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WALL STREET REFORM: OVERSIGHT OF FINANCIAL STABILITY AND CONSUMER AND INVESTOR PROTECTIONS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE AGENCIES' OVERALL IMPLEMENTATION OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT

FEBRUARY 14, 2013

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C O N T E N T S

THURSDAY, FEBRUARY 14, 2013

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ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

WALL STREET REFORM: OVERSIGHT OF FINANCIAL STABILITY AND CONSUMER AND INVESTOR PROTECTIONS

THURSDAY, FEBRUARY 14, 2013

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:33 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. This Committee is called to order.

Before we begin, I would like to extend a warm welcome to Senator Crapo as Ranking Member and to Senator Manchin, Senator Warren, Senator Heitkamp, Senator Coburn, and Senator Heller who are joining us this Congress. I would also like to welcome back my friend Senator Kirk.

Earlier this week I released my agenda for this Congress, and I look forward to this Committee's continued productivity. I am optimistic that we can work together on a bipartisan basis. To that end, Ranking Member Crapo and I sent a letter yesterday to the banking regulators on the importance of carefully implementing Basel III, and I look forward to hearing from each of you, and working with the Ranking Member, on this issue.

Today, this Committee continues a top priority—oversight of Wall Street Reform implementation. Wall Street reform was enacted to make the financial system more resilient, minimize risk of another financial crisis, better protect consumers from abusive financial practices, and ensure American taxpayers will never again be called upon to bail out a failing financial firm. This morning, we will hear from the regulators on how their agencies are carrying out these mandates of Wall Street reform.

Many of the law's remaining rulemakings, like QRM and the Volcker Rule, require careful consideration of complex issues as well as interagency and international coordination. I appreciate your efforts to finalize these rules. To date, the regulators have proposed or finalized over three-fourths of the rules required by Wall Street reform. These include rules that have recently gone "live" in the market, such as the data reporting and registration rules for derivatives that mark new oversight of a previously unregulated market. But there is still more work to do.

That is why I have asked each of our witnesses to provide a progress report to the Committee, both on rulemakings that your agency has completed and those that your agency has yet to finalize. I ask that you craft these rules in a manner that is effective for smaller firms, like community banks, so that they can continue to meet the needs of their customers and communities.

The work does not end when the final rules go out the door. Regulators must enforce the rules, and I ask that each agency inform us how they intend to better supervise the financial system. While concerns have been raised about whether a few firms remain "too big to fail," Wall Street reform provides regulators with new tools to address the issue head on. This is one of the many reasons why full implementation of the law remains important, not just for our constituents but for future generations.

As we approach the 5-year anniversary of the failure of Bear Stearns, we must not lose sight of why we passed Wall Street reform. Congress enacted the law in the wake of the most severe financial crisis in the lifetime of most Americans. How costly was it? I asked the GAO to study this question to better understand the impact the crisis had on our Nation. In a report released today, which I am entering in the record, the GAO concluded that while the precise cost of the crisis is difficult to calculate, the total damage to the economy may be as high as $13 trillion. I say again, 13 trillion—with a "T"—dollars. Thus, I urge you to consider the benefits of avoiding another costly, devastating crisis as you continue implementing Wall Street reform.

I would like to make one final comment on Director Cordray and the CFPB. Since he was appointed as the head of the CFPB last year, Director Cordray and the CFPB have worked tirelessly to finalize many rules and policies to protect consumers in areas such as mortgages, student lending, servicemembers' rights, and credit cards. He has done good work, and I urge my colleagues to confirm Director Cordray to a full term without delay and allow the CFPB to continue its important work protecting consumers.

I now turn to Ranking Member Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman. You and I have a very good personal friendship and have had a good working relationship over the years, and I look forward to building on that and working with you as the Ranking Member of the Committee this year, this Congress.

One of my objectives and hopes would be to work together on the kind of commonsense bipartisan solutions that we can achieve before this Committee in a number of areas that I think various Members of the Committee have already identified and discussed among ourselves.

We, you and I, as you indicated, have already sent a joint letter to inform the regulators of our concerns about the impact of the proposed Basel III requirements on community banks, insurance companies, and the mortgage market, and so we are off to a good start. I look forward to building on that.

I also want to join with you in welcoming the new Members of our Committee: on our side, Senators Coburn and Heller; and on your side, also Senators Manchin, Warren, and Heitkamp. We welcome you to the Committee.

Today, the Committee will hear about the ongoing implementation of Dodd-Frank. Academic researchers estimate that when Dodd-Frank is fully implemented, there will be more than 13,000 new regulatory restrictions in the Code of Federal Regulations. Over 10,000 pages of regulations have already been proposed, requiring, as is estimated, over 24 million compliance hours each year, and that is just the tip of the iceberg. Of some 400 rules required by Dodd-Frank, roughly one-third have been finalized, about one-third have been proposed but not finalized, and roughly one-third have not even yet been proposed. Together, the hundreds of Dodd-Frank proposed rules are far too complex, offering confusing and often contradictory standards and regulatory requirements.

I am concerned that the regulators do not understand and are not focusing aggressively enough on the cumulative effect of the hundreds of proposed rules and that there is a lack of coordination among the agencies, both domestically and internationally. That is why it is important for the regulators to perform meaningful cost/benefit analysis so that we can understand how these rules will affect the economy as a whole, interact with one another, and impact our global competitiveness.

An enormous number of new rules are slated to be finalized this year as a result of Dodd-Frank, Basel III, and other regulatory initiatives. And at this important juncture, we need answers to critical questions.

First, what are the anticipated cumulative effects of these new rules to credit, liquidity, borrowing costs, and the overall economy? Ultimately, we need rules that are strong enough to make our financial system safer and sounder, but that can adapt to changing market conditions and promote credit availability and spur job growth for millions of Americans.

Second, what have the agencies done to assess how these complicated rules will interact with each other and the existing regulatory framework? I am hearing a lot of concern about how the interaction of some rules will reduce mortgage credit through the qualified mortgage rule, the proposed qualified residential mortgage rule, and the proposed international Basel III risk weights for mortgages, as an example.

And, third, what steps are being taken to fix the lack of coordination and harmonization of rules among the United States and international regulators on cross-border issues? For example, the CFTC has issued a number of so-called guidance letters and related orders on cross-border issues. The CFTC's initial proposal received widespread criticism from foreign regulators that the guidance is confusing, expansive, and harmful. Meanwhile, the SEC has not yet issued its cross-border proposal.

There is bipartisan concern that some of the Dodd-Frank rules go too far and need to be fixed. A good starting point would be to fulfill congressional intent by providing an explicit exemption from the margin requirements for nonfinancial end users that qualify for the clearing exemption. Similar language to this passed the House last year by a vote of 370–24. Federal Reserve Chairman Bernanke has confirmed that, regardless of congressional intent, the banking regulators view the plain language of the statute as requiring them to impose some kind of margin requirement on nonfinancial end users unless Congress changes the statute.

Unless Congress acts, new regulations will make it more expensive for farmers, manufacturers, energy producers, and many small business owners across the country to manage their unique business risks associated with their day-to-day operations. An end user fix is just one example of the kind of bipartisan actions that we can take to improve the safety and soundness of our financial system without unnecessarily inhibiting economic growth.

It is my hope that today's hearing is going to provide us a starting point to address these critical issues and identify the needed reforms that we must undertake.

Thank you, Mr. Chairman, again for holding this hearing.

Chairman JOHNSON. Thank you, Senator Crapo.

This morning, opening statements will be limited to the Chairman and Ranking Member to allow more time for questions from the Committee Members. I want to remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit.

Now I would like to introduce our witnesses.

Mary Miller is the Under Secretary for Domestic Finance of the U.S. Department of the Treasury.

Dan Tarullo is a member of the Board of Governors of the Federal Reserve System.

Martin Gruenberg is the Chairman of the Federal Deposit Insurance Corporation.

Tom Curry is the Comptroller of the Currency.

Richard Cordray is the Director of the Consumer Financial Protection Bureau.

Elisse Walter is the Chairman of the Securities and Exchange Commission.

And Gary Gensler is the Chairman of the Commodity Futures Trading Commission.

I thank all of you again for being here today.

I would like to ask the witnesses to please keep your remarks to 5 minutes. Your full written statements will be included in the hearing record.

Under Secretary Miller, you may begin your testimony.

STATEMENT OF MARY J. MILLER, UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

Ms. MILLER. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you so much for the opportunity to be here today.

The Dodd-Frank Wall Street Reform and Consumer Protection Act represents the most comprehensive set of reforms to the financial system since the Great Depression. Americans are already beginning to see benefits from these reforms reflected in a safer and stronger financial system.

Although the financial markets have recovered more vigorously than the overall economy, the economic recovery is also gaining traction. The financial regulators represented here today have been making significant progress implementing Dodd-Frank Act reforms.

Treasury's specific responsibilities under the Dodd-Frank Act include standing up new organizations to strengthen coordination of financial regulation both domestically and internationally, improve information sharing, and better address potential risks to the financial system.

Over the past 30 months, we have focused considerable effort on creating the Financial Stability Oversight Council, the Office of Financial Research, and the Federal Insurance Office.

The Financial Stability Oversight Council, known as FSOC, has become a valuable forum for collaboration among financial regulators. Through frank discussion and early identification of areas of common interests, the financial regulatory community is now better able to identify issues that would benefit from enhanced coordination. Although FSOC members are required to meet only quarterly, the FSOC met 12 times last year to conduct its regular business and respond to specific market developments. Much additional work takes place at the staff level with regular and substantive engagement to inform FSOC leaders.

While Treasury is not a rule-writing agency, the Treasury Secretary has a statutory coordination role for the Volcker Rule and risk retention rule by virtue of his chairmanship of the FSOC. We take that role very seriously and will continue to work with the respective rulemaking agencies as they finalize these rules.

In addition to the FSOC's coordination role, it has certain authority to make recommendations to the responsible regulatory agencies where a financial stability concern calls for further action. An example along these lines is a concern about risks in the short-term funding markets. The FSOC's focus on this ultimately led the Council to issue proposed recommendations on money market fund reforms for public comment.

The FSOC has also taken significant steps to designate and increase oversight of financial companies whose failure or distress could negatively impact financial markets or the financial stability of the United States. Treasury has made significant progress in establishing the Office of Financial Research and the Federal Insurance Office. The OFR provides important data and analytical support for the FSOC and is developing new financial stability metrics and indicators. It also plays a leadership role in the international initiative to establish a Legal Entity Identifier, a code that uniquely identifies parties to financial transactions. The planned launch of the LEI next month will provide financial companies and regulators worldwide a better view of companies' exposures and counterparty risks.

With the establishment of the Federal Insurance Office, the United States has gained a Federal voice on insurance issues, domestically and internationally. For example, in 2012, FIO was elected to serve on the Executive Committee of the International Association of Insurance Supervisors and is now providing important leadership in developing international insurance policy.

We are also working internationally to support efforts to make financial regulations more consistent worldwide. By moving early with the passage and implementation of the Dodd-Frank Act, we are leading from a position of strength in setting the international reform agenda. This comprehensive agenda spans global bank capital and liquidity requirements, resolution plans for large multinational financial institutions, and derivatives markets. We will continue to work with our partners around the world to achieve global regulatory convergence.

As we move forward, it is critical to strike the appropriate balance of measures to protect the strength and stability of the U.S. financial system while preserving liquid and efficient markets that promote access to capital and economic growth. Completion of these reforms provides the best path to achieving continued economic growth and prosperity grounded in financial stability.

Thank you for the opportunity to testify today. I would welcome any questions the Committee may have.

Chairman JOHNSON. Thank you.

Governor Tarullo, please proceed.

STATEMENT OF DANIEL K. TARULLO, GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. TARULLO. Thank you, Mr. Chairman, Senator Crapo, and other Members of the Committee. It is a pleasure to be with all of you here on this Valentine's Day. I just wanted to make two points in these oral remarks.

First, I hope that 2013 will be the beginning of the end of the major portion of rulemakings implementing Dodd-Frank and strengthening capital rules. The rulemaking process has been very time-consuming. In some cases, it has run beyond the deadline set by Congress, though there have been some good reasons for that. Joint rulemaking just takes a lot of time, and for many of the rules, that process involves three to five independent agencies, representing between 12 and 22 individuals who have votes at those agencies. Also, some of the rules involve subjects that are complicated, controversial, or both.

I think there was wide agreement that it was incumbent on the regulators to take the time to understand the issues and to give full consideration to the many thousands of comments that were submitted on some of the proposals.

But it is also important to get to the point where we can provide clarity to financial firms as to what regulatory environment they can expect in some of these important areas so that they can get on with planning their businesses accordingly.

So it is my hope and my expectation that, with respect to the Volcker Rule, the capital rules, Section 716, and many of the special prudential requirements for systemically important firms, we will publish final rules this year.

On Volcker, and on the standardized capital rules in particular, I think the agencies have learned a good deal from the formal comments and public commentaries addressed to these proposals. Both required a difficult balance between the aims of comprehensiveness on the one hand and administrability at firms and at regulators on the other. I think it is pretty clear that both proposals lean too far in the direction of complexity, and I would expect a good bit of change in the final rulemakings on these subjects.

Indeed, these examples prove the wisdom of those who drafted the Administrative Procedures Act many years ago whereby they set up a process that agencies issue proposals for notice and comment, receive comments, consider the comments, modify the regulations, and then finally put those regulations into place.

We should also get out proposals this year to implement two arrangements agreed internationally: the capital surcharge for systemically important banks and the liquidity coverage ratio.

One exception where we will be slowing down a little—and here "we" as in the Federal Reserve, not our fellow agencies—is the Section 165 requirement for counterparty credit risk limits. Based on the comments received and ongoing internal staff analysis, we concluded that a quantitative impact study was needed to help us assess better the optimal structure of a rule that is breaking new ground in an area for which there is a lot of hard, but heretofore uncollected, data. So we are going to need some more time on this one.

The second point I want to make is that the feature of the financial system that is in most need of further attention and regulatory action is that of nondeposit short-term financing. My greatest concern is with those parts of the so-called shadow banking system that are susceptible to destabilizing funding runs, something that is more likely where the recipients of the short-term funding are highly leveraged, engaged in substantial maturity transformation, or both. It was just these kinds of runs that precipitated the most acute phase of the financial crisis that the Chairman referred to a few moments ago.

We need to continue to assess the vulnerabilities posed by this kind of funding while recognizing that many forms of short-term funding play important roles in credit intermediation and productive capital market activities.

But we should not wait for the emergence of a consensus on comprehensive measures to address these kinds of funding channels. That is why I suggest in my written testimony more immediate action in three areas: the transparency of securities financing, money market mutual funds, and triparty repo markets.

Thank you all for your attention.

Chairman JOHNSON. Thank you.

Chairman Gruenberg, please proceed.

STATEMENT OF MARTIN J. GRUENBERG, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. GRUENBERG. Thank you, Mr. Chairman. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to testify today on the FDIC's efforts to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act. While my prepared testimony addresses a range of issues, I will focus my oral remarks on three areas of responsibility specific to the FDIC: deposit insurance, systemic resolution, and community banks.

With regard to the deposit insurance program, the Dodd-Frank Act raised the minimum reserve ratio for the Deposit Insurance Fund to 1.35 percent and required that the reserve ratio reach this level by September 30, 2020. The FDIC is currently operating under a DIF Restoration Plan that is designed to meet this deadline, and the DIF reserve ratio is recovering at a pace that remains on track to achieve the plan. As of September 30, 2012, the reserve ratio stood at 0.35 percent of estimated insured deposits. That is up from 0.12 percent a year earlier. The fund balance has now grown for 11 consecutive quarters, increasing to $25.2 billion at the end of the third quarter of 2012.

The FDIC has also made significant progress on the rulemaking and planning for the resolution of systemically important financial institutions, so-called SIFIs. The FDIC and the Federal Reserve Board have jointly issued the basic rulemaking regarding resolution plans that SIFIs are required to prepare. These are the so-called living wills. The rule requires bank holding companies with total consolidated assets of $50 billion or more to develop, maintain, and periodically submit resolution plans that are credible and that would enable these entities to be resolved under the Bankruptcy Code. On July 1, 2012, the first group of living will filings by the nine largest institutions with nonbank assets over $250 billion was received, with the second group to follow by July 1st of this year, and the rest by December 31st. The Federal Reserve and the FDIC are currently in the process of reviewing the first group of plan submissions.

The FDIC has also largely completed the rulemaking necessary to carry out its systemic resolution responsibilities under Title II of the Dodd-Frank Act. The final rule approved by the FDIC board addressed, among other things, the priority of claims and the treatment of similarly situated creditors.

Section 210 of the Dodd-Frank Act expressly requires the FDIC to coordinate, to the maximum extent possible, with appropriate foreign regulatory authorities in the event of the resolution of a systemic financial company with cross-border operations.

In this regard, the FDIC and the Bank of England, in conjunction with the prudential regulators in our respective jurisdictions, have been working to develop contingency plans for the failure of SIFIs that have operations in both the U.S. and the U.K. In December, the FDIC and the Bank of England released a joint paper, providing an overview of the work we have been doing together.

In addition, the FDIC and the European Commission have agreed to establish a joint working group to discuss resolution and deposit insurance issues common to our respective jurisdictions. The first meeting of the working group will take place here in Washington next week.

Finally, in light of concerns raised about the future of community banking in the aftermath of the financial crisis, as well as the potential impact of the various rulemakings under the Dodd-Frank Act, the FDIC engaged in a series of initiatives during 2012 focusing on the challenges and opportunities facing community banks in the United States. In December of last year, the FDIC released the FDIC Community Banking Study, a comprehensive review of the U.S. community banking sector covering the past 27 years of data.

Our research confirms the important role that community banks play in the U.S. financial system. Although these institutions account for just 14 percent of the banking assets in the United States, they hold 46 percent of all the small loans to businesses and farms made by FDIC-insured institutions. The study found that for over 20 percent of the counties in the United States, community banks are the only FDIC-insured institutions with an actual physical presence.

Importantly, the study also found that community banks that stayed with their basic business model—careful relationship lending funded by stable core deposits—exhibited relatively strong and stable performance over this period and during the recent financial crisis, and should remain an important part of the U.S. financial system going forward.

Mr. Chairman, that concludes my oral remarks. I would be glad to respond to your questions.

Chairman JOHNSON. Thank you.

Comptroller Curry, please proceed.

STATEMENT OF THOMAS J. CURRY, COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. CURRY. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, it is a pleasure to appear before you today for this panel's first hearing of the new Congress. I want to thank Chairman Johnson for his leadership in holding this hearing, and I would also like to congratulate Senator Crapo on his new role as the Ranking Member of this Committee. I look forward to working with both of you on many issues facing the banking system. There are also a number of new Members on the Committee, and I look forward to getting to know each of you better this session.

It has been nearly 3 years since the Dodd-Frank Act was enacted, and both the financial condition of the banking industry and the Federal regulatory framework have changed significantly. The OCC supervises more than 1,800 national banks and Federal savings associations, which together hold more than 69 percent of all commercial bank and thrift assets. They range in size from very small community banks with less than $100 million in assets to the Nation's largest financial institutions with assets exceeding $1 trillion. More than 1,600 of the banks and thrifts we supervise are small institutions with less than $1 billion in assets, and they play a vital role in meeting the financial needs of communities across the Nation.

I am pleased to report that Federal banks and thrifts have made significant strides since the financial crisis in repairing their balance sheets through stronger capital, improved liquidity, and timely recognition and resolution of problem loans.

While these are encouraging developments, banks and thrifts continue to face significant challenges, and our examiners continue to stress the need for these institutions to remain vigilant in monitoring the risks they take on in this environment.

We are also mindful that we cannot let the progress that has been made in repairing the economy and in strengthening the banking system lessen our sense of urgency in addressing the weaknesses and flaws that were revealed by the financial crisis. The Dodd-Frank Act addresses major gaps in the regulatory landscape, tackles systemic issues that contributed to and amplified the effects of the financial crisis, and lays the groundwork for a stronger financial system.

Like my colleagues at the table, we at the OCC are currently engaged in numerous rulemakings, from appraisals to Volcker and from risk retention to swaps. My written statement provides details on each of these efforts and provides a flavor of some of the public comments that have been submitted.

The OCC is committed to implementing fully those provisions where we have sole rule-writing authority as quickly as possible. We are equally committed to working cooperatively with our colleagues on those rules that require coordinated or joint action. I remain very hopeful that we will soon have in place final regulations in several areas to provide the clarity the industry needs.

Throughout this process, I have been keenly aware of the critical role that community banks play in providing consumers and small businesses in communities across the Nation with essential financial services and access to credit. As the OCC undertakes every one of these critical rulemakings, we are very focused on ensuring that we put standards in place that promote safety and soundness without adding unnecessary burden to community banks.

I would like to highlight one of the most significant milestones of the Dodd-Frank Act for the OCC, which is the successful integration of the mission and most of the employees from the Office of Thrift Supervision into the OCC. The integration was accomplished smoothly and professionally, reflecting the merger of experience with a strong vision for the future. The final stage of this process is underway with the integration of rules of applicable to Federal thrifts with those that apply to national banks consistent with the statutory differences between the two charter types. An integrated set of rules will benefit both banks and thrifts.

In the vast majority of the rulemaking activities, the OCC is one of several participants. The success of those rulemakings depends on interagency cooperation, and I want to acknowledge the work of my colleagues at this table and their staff for approaching these efforts thoughtfully and productively, giving careful consideration to all issues. Working together, I believe we will be able to develop rules that will be good for the financial system, the entities we regulate, and the communities they serve going forward.

Thank you for your attention, and I look forward to answering any questions you may have.

Chairman JOHNSON. Thank you.

Director Cordray, please proceed.

STATEMENT OF RICHARD CORDRAY, DIRECTOR, CONSUMER FINANCIAL PROTECTION BUREAU

Mr. CORDRAY. Thank you, Chairman Johnson, Ranking Member Crapo, and Members of the Committee, for inviting me back today. My colleagues and I at the Consumer Financial Protection Bureau are always happy to testify before the Congress, something we have done now 30 times.

Today we are here to talk about the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the signature legislation that created this new consumer agency.

Since the Bureau opened for business in 2011, our team has been hard at work. We are examining both banks and nonbank financial institutions for compliance with the law, and we have addressed and resolved many issues through these efforts to date. In addition, for consumers who have been mistreated by credit card companies, we are, in coordinated enforcement actions with our fellow regulators, returning roughly $425 million to their pockets. For those consumers who need information or want help in understanding financial products and services, we have developed AskCFPB, a data base of hundreds of answers to questions frequently asked of us by consumers. And our Consumer Response center has helped more than 100,000 consumers with their individual problems related to their credit cards, mortgages, student loans, and bank accounts.

In addition, we have been working hard to understand, address, and resolve some of the special consumer financial issues affecting specific populations: students, servicemembers, older Americans, and those are unbanked or under-banked. And we are planning a strong push in the future for broader and more effective financial literacy in this country. We need to change the fact that we send many thousands of our young people out into the world every year to manage their own affairs with little or no grounding in personal finance education. We want to work with each of you on these issues on behalf of your constituents.

We have also faithfully carried out the law that Congress enacted by writing rules designed to help consumers throughout their mortgage experience—from signing up for a loan to paying it back. We have written rules dealing with loan originator compensation, giving consumers better access to their appraisal reports, and addressing escrow and appraisal requirements for higher-priced mortgage loans.

Just last month, we released our Ability-to-Repay rule, which protects consumers shopping for a loan by requiring lenders to make a good faith, reasonable determination that consumers can actually afford to pay back their mortgages. The rule outlaws so-called and very irresponsible "NINJA" loans—even with no income, no job, and no assets, you could still get a loan—that were all too common in the lead-up to the financial crisis. Our rule also strikes a careful balance on access-to-credit issues that are so prevalent in the market today by enabling safer lending and providing greater certainty to the mortgage market.

Finally, the Bureau also recently adopted mortgage servicing rules to protect borrowers from practices that have plagued the industry like failing to answer phone calls, routinely losing paperwork, and mishandling accounts. I am sure that each of you has heard from constituents in your States who have these kinds of stories to tell.

We know the new protections afforded by the Dodd-Frank Act and our rules will no doubt bring great changes to the mortgage market. We are committed to doing what we can to achieve effective, efficient, complete implementation by engaging with all stakeholders, especially industry, in the coming year. We know that it is in the best interests of the consumer for the industry to understand these rules—because if they cannot understand, they cannot properly implement.

To this end, we have announced an implementation plan. We will publish plain-English summaries. We will publish readiness guides to give industry a broad checklist of things to do to prepare for the rules taking effect next January—like updating their policies and procedures and providing training for staff. We are working with our fellow regulators to ensure consistency and examinations of mortgage lenders under the new rules and to clarify issues as needed. We also are working to finalize further proposals in these rules to recognize that, as my colleagues have said, the traditional lending practices of smaller community banks and credit unions are worthy of respect and protection.

So thank you again for the opportunity to appear before you today and speak about the progress we are making at the Consumer Financial Protection Bureau. We always welcome your thoughts about our work, and I look forward to your questions.

Thank you.

Chairman JOHNSON. Thank you.

Chairman Walter, please proceed.

STATEMENT OF ELISSE B. WALTER, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Ms. WALTER. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, Thank you for inviting me to testify on behalf of the Securities and Exchange Commission regarding our ongoing implementation of the Dodd-Frank Act.

As you know, the act required the SEC to undertake the largest and most complex rulemaking agenda in the history of the agency. We have made substantial progress writing the huge volume of new rules mandated by the act. We have proposed or adopted over 80 percent of the more than 90 required rules, and we have finalized almost all of the studies and reports Congress directed us to write.

Since the law's enactment, our staff has worked closely with other regulatory agencies and has carefully reviewed the thousands of comments we received to ensure that we not only get the rules done but that we get them done right. And I am committed to doing both. Indeed, as long as I serve a Chairman, I will continue to push the agency forward to implement Dodd-Frank.

While my written testimony describes in greater detail what we have achieved, I wanted to touch briefly on just a few of the items.

Today, as a result of new rules jointly adopted with the CFTC, systemic risk information is now being periodically reported by registered investment advisers who manage at least $150 million in private fund assets. This information is providing FSOC and the Commission with a broader view of the industry than we had in the past. Additionally, because of our registration rules, we now have a much more comprehensive view of the hedge fund and private fund industry.

We also adopted rules creating a new whistleblower program, and last year our program produced its first award. We expect future payments to further increase the visibility of the program and lead to even more valuable tips. The program is pulling in the type of high-quality information that reduces the length of investigations and saves resources.

With respect to the new oversight regime Dodd-Frank mandated for over-the-counter derivatives, we have proposed substantially all of the core rules to regulate security-based swaps. Last year in particular, we finalized rules regarding product and party definitions, adopted rules relating to clearing and reporting, and issued a road map outlining how we plan to implement the new regime. Soon we plan to propose how this regime will be applied in the cross-border context. The Commission has chosen to address cross-border issues in a single proposing release rather than through individual rulemakings. We believe this approach will provide all interested parties with the opportunity to consider as an integrated whole the Commission's proposed approach to cross-border security-based swap oversight.

Last year, the Commission, working with the CFTC and the Fed, adopted rules requiring registered clearing agencies to maintain certain risk management standards and also established record keeping and financial disclosure requirements. These rules will strengthen oversight of securities clearing agencies and help to ensure that clearing agency regulation reduces systemic risk in the financial markets.

Although tremendous progress has been made, work remains in areas such as credit rating agencies, asset-backed securities, executive compensation, and the Volcker Rule. With respect to the Volcker Rule, the issues raised are complex, and the nearly 19,000 comment letters received in response to the proposal speak to the multitude of viewpoints that exist. We are actively working with the Federal banking agencies, the CFTC, and the Treasury in an effort to expeditiously finalize this important rule.

With respect to all of our rules, economic analysis is critical. While certain costs or benefits may be difficult to quantify or value with precision, we continue to be committed to meeting these challenges and to ensuring that the Commission engages in sound, robust economic analysis in its rulemaking.

It also has been clear to me from the outset that the act's significant expansion of the SEC's responsibilities cannot be handled appropriately with the agency's current resource levels. With Congress' support, the SEC's fiscal year 2012 appropriation permitted us to begin hiring some of the new positions needed to fulfill these responsibilities.

Despite this, the SEC does not yet have all the resources necessary to fully implement the law. Enactment of the President's fiscal year 2013 budget would help us to fill the remaining gaps by hiring needed employees for frontline positions and also would permit us, importantly, to continue investing in technology initiatives that substantially and cost-effectively allow us to improve our ability to police the markets.

As you know, regardless of the amount appropriated, our budget will be fully offset by fees we collect and will not impact the Nation's budget deficit.

As the Commission strives to complete our remaining tasks, we look forward to working with this Committee and others to adopt rules that fulfill our mission of protecting investors, maintaining fair, orderly, and efficient markets, and facilitating capital formation.

Thank you again for inviting me to share with you our progress to date and our plans going forward. I look forward to answering your questions.

Chairman JOHNSON. Thank you.
Chairman Gensler, please proceed.

STATEMENT OF GARY GENSLER, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. GENSLER. Thank you, Chairman Johnson, Ranking Member Crapo, and Members of the Committee. I want to first just associate myself with Governor Tarullo's comments about wishing you well on this Valentine's Day, but also his comments about the Administrative Procedures Act. I think we have all benefited at the CFTC by the 39,000 comments that we have gotten on our various rules.

This hearing is occurring at a very historic time in the markets because, with your direction, the CFTC now oversees the derivatives marketplace—not only the futures marketplace that we had overseen for decades, but also this thing called the swaps marketplace that, through Dodd-Frank, you asked us to oversee.

Our agency has actually completed 80 percent, not just proposed but completed 80 percent of the rules you asked us to do. And the marketplace is increasingly shifting to implementation of these commonsense rules of the road.

So what does it mean? Three key things:

For the first time, the public is benefiting from seeing the price and volume of each swap transaction. This is free of charge on a Web site. It is like a modern-day ticker tape.

Second, for the first time, the public will benefit from greater access to the market that comes from centralized clearing and the risk reduction that comes from that centralized clearing. This will be phased throughout 2013, but we are not needed to do any new rules. It is all in place.

And, third, for the first time, the public is benefiting from the oversight of swap dealers—we have 71 of them that registered—for sales practices and business conduct to help lower risk to the overall economy.

Now, these swaps market reforms ultimately benefit end users. The end users in our economy, the nonfinancial side, employs 94 percent of private sector jobs, and these benefit those end users through greater transparency. Greater transparency starts to shift some information advantage from Wall Street to Main Street, but also lowering risk. And we have completed our rules ensuring, as Congress directed, that the nonfinancial end users are not required to participate in central clearing. And as Ranking Member Crapo said, at the CFTC we have proposed margin rules that provide that end users will not have to post margin for those uncleared swaps.

To smooth the market's transition to the reform, the Commission has consistently been committed to phasing in compliance based upon the input from the market participants. I would like to highlight two areas in 2013 that we still need to finish up the rules.

One is completing the pretrade transparency reforms. This is so buyers and sellers meet, compete in the marketplace, just as in the securities and futures marketplace. We have yet to complete those rules on the swap execution facilities and block rules.

Second, ensuring that cross-border application of swaps market reform appropriately covers the risk of U.S. affiliates operating offshore. We have been coordinating greatly with our international colleagues and the SEC and the regulators at this table, but I think in enacting financial reform, Congress recognized a basic lesson of modern finance and the crisis. That basic lesson is that during a crisis, during a default, risk knows no geographic border. If a run starts in one part of a modern financial institution, whether it is here or offshore, it comes back to hurt us. That was true in AIG, which ran most of its swaps business out of Mayfair—that is a part of London—but it was also true at Lehman Brothers, Citigroup, Bear Stearns, and Long-Term Capital Management. I think failing to incorporate this basic lesson of modern finance into our oversight of the swaps market would not only fall short of your direction to the CFTC and Dodd-Frank, but I also think it would leave the public at risk. I believe Dodd-Frank reform does apply, and we have to complete the rules to apply to transactions entered into branches of U.S. institutions offshore, or their guaranteed affiliates offshore transacting with each other, or even if it is a hedge fund that happens to be incorporated in an island or offshore but it is really operated here.

I would like just to turn with the remaining minute to these cases the CFTC brought on LIBOR because it is so much of our 2013 agenda.

Now, the U.S. Treasury collected $2 billion from the Justice Department and CFTC fines, but that is not the key part of this. What is really important is ensuring financial market integrity. And when a reference rate such as LIBOR, central to borrowing, lending, and hedging in our economy, has so readily and pervasively been rigged, I think the public is just shortchanged. I do not know any other way to put it. We must ensure that reference rates are honest and reliable reflections of observable transactions in real markets and that they cannot be so vulnerable to misconduct.

I will close by mentioning, the same way as Chairman Walter did, the need for resources. I would say the CFTC has been asked to take on a market that is vast in size and much larger than the futures market we once oversaw, and that without sufficient funding, I think the Nation cannot be assured that we can effectively oversee these markets.

I thank you and look forward to your questions.

Chairman JOHNSON. Thank you, and thank you all for your testimony.

As we begin questions, I will ask the clerk to put 5 minutes on the clock for each Member.

Ms. Miller, what steps is the U.S. taking both at home and abroad to complete reforms in a way that makes the financial system safer, ends too-big-to-fail bailouts, and promotes stable economic growth? And what are the challenges to accomplish this?

Ms. MILLER. Thank you for the question. I think the most important thing that we can do is to restore confidence in our financial markets and our financial system, and I think the work that has gone on, post the Dodd-Frank reforms, has been incredibly important in strengthening our financial institutions, making sure that they are better capitalized, that they are more liquid, and that they have a good plan for failure should they not succeed.

I do not think that our reforms are intended to prevent failure, but I think they are intended to make us much better prepared and to make sure that our financial institutions and the activities that they engage in are much safer and sounder.

So we have been working very hard, I think, in the U.S. and abroad with our international counterparts to make sure that we have put in place the necessary rules of the road to make sure these things can happen.

So it is happening at many levels in the U.S. You have heard of all of the activities that these financial regulators are engaged in. But it is also happening in international forums where we are working with our counterparts to make sure that we have a level playing field.

As far as the challenges, this is a very comprehensive law. It is one that addresses many parts of our financial system. I think the number of rulemaking activities, definitions, studies, and work that were laid out by Dodd-Frank is quite a big workload. When I work with these regulators here, I see the same people in many instances working on a wide range of rules. They are working very hard. But they have a pretty big agenda to accomplish. But I think that the spirit of cooperation is good. I think entities like the Financial Stability Oversight Council provide a good forum for working on these things.

Chairman JOHNSON. Mr. Cordray, congratulations on issuing a final QM rule that was well received by both consumer advocates and the industry. What approach did you take to design a final rule to strike the right balance?

Mr. CORDRAY. Thank you, Mr. Chairman, and I appreciate those observations. I think we tried to do three things.

The first is that we were very accessible to all parties with all ranges of viewpoints on the issues. The issues were difficult. It is not easy to write rules for the mortgage market right now because we are in an unnaturally tight period, and the data from a few years before was from an unnaturally loose period, and we have some significant issues unresolved in terms of public policy. We listened very carefully and attentively to what people had to say to us and the great deal of comments that we received.

Secondly we did go back and try to develop additional data so that we could work through the numbers on our own and understand what kind of effects different potential approaches would have.

Third and this was quite meaningful—we consulted very closely with our fellow agencies. They have a lot of expertise and a lot of insight on the kinds of problems we were addressing, and we will ultimately be examining these institutions in parallel to one another. And the rules need to work for everyone.

We will continue to work with the other agencies on implementation, and I do think that that helped us tremendously. I could point to any number of provisions in the rules that were made better by that process.

Chairman JOHNSON. This question is for Mr. Gruenberg, Mr. Curry, and Mr. Tarullo. First, I want to thank Senator Hagan for all her hard work on QRM. Is there anything in the law that would prohibit QRM from being defined the same as QM? And is that something you are considering now that the QM rule is finalized, as Mr. Cordray just described? Mr. Gruenberg, let us begin with you.

Mr. GRUENBERG. Thank you, Mr. Chairman. I do not believe there is any prohibition in the law with regard to conforming QRM with QM. We actually delayed consideration of the rulemaking on QRM pending the completion of the QM rules, and I think we will now have the ability to consider the final rulemaking on QRM in light of that QM rulemaking.

Chairman JOHNSON. Mr. Tarullo and Mr. Curry, do you agree?

Mr. TARULLO. Certainly, Mr. Chairman, I agree with Chairman Gruenberg that there is no legal bar. And I would just say further that, as you know, the two provisions had somewhat different motivations. The QM rule was motivated toward protecting the individual who buys the house, and the QRM rule was motivated toward the risk retention associated with that mortgage and, thus, presumably trying to protect the investment for the intermediary.

Having said that, I think given the state of the mortgage market right now—and both you and Senator Crapo have alluded to it—we want to be careful here about the incremental rulemaking that we are doing not beginning to constrict credit to middle- and lower-middle-class people who might be priced out of the housing market if there is too much in the way of duplicate or multiple kinds of requirements at the less than highly creditworthy end.

So I think it is definitely the case that on the table should be consideration of making QRM more or less congruent with QM.

Chairman JOHNSON. Mr. Curry.

Mr. CURRY. I share the views of both Governor Tarullo and Chairman Gruenberg with respect to the definition. I also would concur with Governor Tarullo that it is important to look at the cumulative effect, the issue that Senator Crapo mentioned, when we are talking about the mortgage market and issues of competition, and the ability to have the widest number of financial institutions, regardless of size, participating in it is something that we are very concerned about and paying close attention to.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman. Senator Corker has a need to get to another meeting, and I am going to yield to him.

Senator CORKER. Thank you. Thank you very much. I will do this rarely, and I will be very brief, just three questions.

Mr. Gruenberg, we talked extensively, I think, about orderly liquidation in Title II, and I know most people thought orderly liquidation meant that these institutions would be out of business and gone. I think as you have gotten into it, you have decided that you are only going to eliminate the holding company level. And what that means is that creditors, candidly, could issue debt to all the subsidiaries and know that they are never going to be at a loss. And I am just wondering if you have figured out a way to solve that, because obviously that was not what was intended.

Mr. GRUENBERG. I agree with you, Senator, and as you know, the approach we have been looking at would impose losses—actually wiping out shareholders, imposing losses on creditors, and replacing culpable management. In regard to creditors, it would be important to have a sufficient amount of unsecured debt at the holding company level in order to make this approach work. We have been working closely with the Federal Reserve on this issue. Actually, Governor Tarullo in his testimony makes reference to it, and I am hopeful we can achieve an outcome that will allow us to impose that kind of accountability on creditors.

Senator CORKER. It seems like you would want all of your long-term debt at the holding company level, so I just hope that you all will work something out that is very different than the way it is right now, because creditors could easily be held harmless by just making those loans at the sub-level, and that is not what anybody intended.

Second, with the FSOC, Ms. Miller and Mr. Tarullo, I know that you are to identify and to respond to threats in the financial system, any kind of systemic threat, and I would just ask the two of you: Is there any institution in America today that, if it failed, would pose a systemic risk? Any institution.

Ms. MILLER. Well, I think we learned from the financial crisis that the failure of a large institution can create some systemic risk, so I——

Senator CORKER. But you all are to eliminate that, so I am just wondering if any institution in America failed, would that create systemic risk? Because your job is to ensure that that is not the case.

Ms. MILLER. I believe that all the work that we have done and continue to do is designed to prevent that effect and to make sure that we have in place rules and regulations that keep firms from engaging in activities or building their business models in ways that are going to transmit that type of financial distress.

Senator CORKER. Mr. Tarullo.

Mr. TARULLO. I think, Senator, that it is a journey and not a single point where you can say we have addressed the too-big-to-fail issue. I do think a lot of progress has been made. But I would also distinguish between, if I can put it this way, resolvability without a disorderly, major disruption to the financial system on the one hand, and on the other the failure of a firm that entails substantial negative externalities. So it is the difference between bringing the whole system into crisis on the one hand, not doing so on the other, but still imposing lots of costs.

And I do think that there is complementarity between the capital rules, the FDIC resolution process, and the other rules in trying to make sure that we are dealing both with resolvability and negative externality.

Senator CORKER. I hear what you are both saying. I would assume, though, that a big part of your role is to ensure that there is no institution—I know that you guys have regulatory regimes that try to keep them healthy. But I assume—and if I am wrong—that you want to ensure that there is no institution in America that is operating, that operates that can fail and create systemic risk. I assume that is part of your role, and if not, I would like a follow-up after the meeting, and maybe we will ask that again in written testimony. I know my time is short.

Let me just close with this. I know the Basel III rules are really complicated as it relates to capital, and some people, Mr. Tarullo, have come out and said that we would be much better off with a much stronger capital ratio—some people have said 8 percent—and do away with all the complexities that exist, because many of the schemes, if you will, that lay out risk really do not work so well. I am just wondering if that would not be a better solution to Basel III, and that is, just have much better ratios, much stronger ratios, and much less complexity with all of these rules that so many people are having difficulty understanding.

Mr. TARULLO. Well, Senator, I guess I would say—and I know you are not making the observation I am about to respond to, but it has been heard as well—the idea that if you somehow do not completely like Basel III or think maybe more should have been done, that we should not be for Basel III. Basel III is an enormous advancement in improving the quantity and the quality of capital, and those pieces of it are actually not all that complicated. You know, making sure that the equity that is held is real equity that can be loss absorbing and getting it up to a 7-percent level, effectively, rather than as low as 2 percent, which that level was precrisis. I think those are pretty straightforward.

Whether more should be done, whether as Chairman Gruenberg was just saying, for some of the largest institutions we need some complementary measures, we certainly think with systemic risk you do. I agree with that. But I actually think it is pretty straightforward, and I would also say that in the U.S., at least, with the Collins amendment, we are now in a position to have a standardized floor with standardized risk weights, not model-driven risk weights but standardized risk weights, which applies to everybody, and my hope would be that other countries actually see there is substantial merit in this, in having a much simpler floor and then above that for the biggest institutions, that is where you have the model-driven supplemental capital requirement, not displacing the simple one, just supplemental.

Senator CORKER. Thank you. Thank you very much.

Chairman JOHNSON. Senator Reed.

Senator REED. Thank you very much, Mr. Chairman.

Chairman Gensler, I understand that you recently had a roundtable on the futurization of swaps, and one of the participants indicated that because the rulemaking process has not been fully completed, many people are moving away to avoid uncertainty in the futures markets. Can you tell us what risks might be posed by that and also how you are going to respond to finalizing these rules? And I know you indicated your budget issue is probably a critical factor in that. You might even comment on that again.

Mr. GENSLER. Thank you, Senator. I think what we are seeing in the derivatives marketplace is somewhat natural. The futures marketplace has been regulated for seven or eight decades and for transparency and risk reduction through clearing. The swaps marketplace developed about 30 years ago and, in fact, is between 80 and 90 percent of the market share in a sense of the outstanding derivatives.

So as Congress dictated, as we bring transparency and central clearing to the unregulated market, there has been some relabeling, some reshifting. As you say, some people call this futurization.

The good news is whether it is a future or a swap, we have transparency after the transaction and in futures before the transaction occurs. We have central clearing to lower the risk and ensure access.

We do need to finish the rules in the swaps marketplace around these things called swap execution facilities and the block rule. We also in the futures world have to ensure that we do not lose something, that what was once swaps moves over and calls itself futures and somehow the exchanges lower the transparency. We would not want to see that happen.

But I think whether it is called a future or a swap, we are in better shape than we were before 2008. I thank you for asking about resources. We desperately need more resources. It is a hard ask when Congress is grappling with the budget deficits, I know.

Senator REED. Commissioner Walter, this is a related question because it is an international market, and both you and Chairman Gensler are working on the issue of cross-border swaps. And in order to coordinate with international regulators so that there is a consistent rule—and it sort of harkens back to what Governor Tarullo said about it would be great if there was a Collins rule across the board. Uniformity, simple uniformity helps sometimes.

Can you comment upon what both you and Chairman Gensler are doing with respect to these coordination efforts with respect to the cross-border swaps?

Ms. WALTER. Absolutely. Thank you, Senator Reed. It is a tremendously important issue, perhaps more important in this market than any other, because this market is truly a global marketplace. Unlike other markets that we regulate which only have certain cross-border aspects, the majority of what goes on in this marketplace really does cross national lines.

We have worked very closely not only with the standard multinational bodies such as IOSCO, the International Organization of Securities Commissions, but both the CFTC and the SEC are working very actively with the regulators around the globe who are in the process of writing the same rules. They are at somewhat different stages than we are. Some are still at the legislative stage. Some are just entering the rule-writing stage. But we all acknowledge the importance of making sure that the business can take place across national boundaries and that we remove unnecessary barricades.

First of all, we want no incompatibility or conflict, but then we also want to look at ways that we can make our rules more consonant. And we are both looking at techniques such as what we call substituted compliance, where you could have an entity that is registered in the United States but complies with its U.S. obligations by complying with its home-country laws. We think this will really ease the burdens, and we are looking at all of it very carefully.

Senator REED. Chairman Gensler, any comments?

Mr. GENSLER. I think we are in far better shape than we were 2 years ago if we had this hearing, or even 1 year ago, because Europe, the European Union, now has a law called AMIR. Canada and Japan and we, so four very significant jurisdictions between which we probably have 85 or 90 percent of this worldwide swaps marketplace.

We are ahead of them in the rule-writing stage, but with some developments last week, even Europe now got their rules through a very important process through the European Parliament. So I think that we are starting to align better.

Senator REED. Let me just make a final comment because my time is expiring. One of the Dodd-Frank initiatives was to take bilateral derivative trades and make them—put them on clearing platforms so that they are multilateral. That helps, but it also engenders the possibility of systemic risk from the large concentration. That means that the collateral rules, all the rules have to be. I just want to leave that thought with you, that you have—you know, that is something that should be of concern to both CFTC and SEC, that these central clearing platforms are so grounded with capital, collateral, however you want to describe it, lack of leverage, that they do not pose systemic risk. I think you understand that.

Mr. GENSLER. We do, and we take that very seriously, and we consult actively with the Federal Reserve and international regulators as well on that.

Senator REED. Thank you very much.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman. I first want to get into the issue of economic analysis. As I know you are all aware, the President has issued two Executive orders requiring the agencies to conduct economic analysis, and the Office of Management and Budget has issued directives and guidance on how to implement that. But, ironically, independent agencies such as yours are not subject to those requirements or to those Executive orders. And I know that each of your agencies has said that you are going to follow the spirit of those orders, but in December of 2011, the GAO found that, in fact, in the rulemaking under Dodd-Frank the agencies were not following the guidances put out by OMB. And in its December report of this year, it found that the OCC and the SEC were getting there, but that the remaining agencies still a year later were not following the key guidances that the OMB has put out for economic analysis.

The GAO, frankly, I think was quite critical about that, as well as the fact that it found some coordination among the agencies, but that the coordination was very informal in nature, and almost none of the coordination looks at the cumulative burden of all the new rules, regulations, and requirements.

So my first question, or really ask, is of all of you: Can I have your commitment that each of your agencies will act on GAO's recommendation to incorporate OMB's guidance on cost/benefit analysis into your proposed and final rules as well as your interpretive guidance? I guess I would not necessarily go through and ask each one of you for an answer, but if there is any agency here who will not commit to comply with the GAO's recommendation, could you speak up?

Mr. TARULLO. I am sorry. I will confess not being familiar with the December 2012 recommendations, Senator. Certainly we do economic analysis both on a rule-by-rule basis and more generally, and to that we are committed. I do not know that we are committed to everything that might be in there, and I just would not want to leave you with that impression. So I would prefer to be able to get back to you after the hearing.

Senator CRAPO. OK. Well, I have got the report here. I am sure you can get a copy of it. And what the GAO is saying is that it is the OMB guidances implementing the President's Executive orders on this issue, and each of the agencies tells the GAO that they are doing what you just said to me, that you are doing economic analysis. The GAO is saying that you are not doing economic analysis the way that the OMB has directed that it be done, according to the guidance.

So the request is that you commit that you will follow the GAO recommendation that you simply comply with the OMB guidances.

All right. I am going to take that as an agreement that you will do that.

Mr. GENSLER. Could I just, because I do not want to leave it——

Senator CRAPO. I guess maybe not.

Mr. GENSLER. Well, no. I just want to make sure, just as Governor Tarullo, that we did not leave you with anything but the best impressions.

Our general counsel and our chief economist issued guidance to the staff on all our rulemakings to ensure that our final rules do what you are saying. I think the GAO report also is looking at some proposals that came before, so we had to sort of, you know, address what the recommendations were, and there were proposals before that.

We are also in a circumstance where our statute has explicit language about cost/benefit considerations, and that language we have is a little different than other agencies. So we look to Section 15(a), I think, of the Commodity Exchange Act for our guidance on cost/benefit. But I believe and I understand that our guidance to the staff is consistent with the OMB, but recognizing we have to comply with the statute that we have.

Senator CRAPO. I do not think that the statute you have, though, stops you from honoring and meeting the OMB guidances. GAO, as I understand it, looked at 66 rulemakings altogether that happened among the agencies law year, and that is a pretty significant amount of the rulemakings that were there.

Let me get at this in another way. Can each of you commit that you will provide the Committee with a description of the specific steps your agency is taking to understand and quantify the anticipated cumulative effect of the Dodd-Frank rules? Any problem with that one?

Mr. TARULLO. We are using data that is available, and where the quantification possibility exists, absolutely.

Senator CRAPO. All right. I see my time is up. I have some other issues to get into with you, but I appreciate this. And I just want to conclude by a statement. I think GAO's report was very clear that the kind of economic analysis that we need is not happening, and that is why I am raising this. So although you explained that you have other regimes or statutory mandates, the issue here is getting at proper economic analysis as we implement these rules.

And I think GAO's report is pretty damning in terms of the results they found on the 66 rules that they identified.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you to all for your testimony.

Mr. Curry, I wanted to discuss the botched foreclosure review process that I held a hearing on more than a year ago in the Housing Subcommittee, and in fairness, let me start off by saying that I realize that you were not the Comptroller when the foreclosure review program was designed. But as the follow-on to that period of time, you are, nevertheless, tasked with cleaning up what I consider to be a mess.

Basically what was done here is that we replaced the process with an $8.5 billion settlement that will not really determine which borrowers were wronged or not, and despite keeping their legal rights to sue the banks, most borrowers do not have the financial means to litigate their cases if they feel that the compensation was inadequate.

So considering this point, isn't it unfair to not review the files of those turning in packages if they still want a review? And would you consider mailing each borrower a check but giving them the option to return that check in favor of a full review of their file? And as part of the answer—I will just give you the third part of it—how is it fair to tell a borrower who had, for example, $10,000 in improper fees charged to them that they are going to get $1,000 because that is the amount that all borrowers in the improper fee category will get?

I have been at this for over a year, and I am concerned about how we are coming to the conclusion here. So give me some insight.

Mr. CURRY. Thank you, Senator Menendez. I share your concerns about the entire process and its ability to meet its original stated objectives.

What happened here is that the complexity of the review process was much larger than was anticipated in the beginning. It consumed a considerable amount of time with very little in terms of results. And our concern was that having over almost $2 billion being spent as of November of this year without being able to even issue the first checks, that the process was flawed and that the best equitable result was to estimate an appropriate amount of settlement and to make as equitable a decision as possible, taking into account the level of harm and the borrower characteristics. The settlement is not perfect, but we believe it is the best possible outcome under the circumstances.

Senator MENENDEZ. On the specific questions that I asked you, though, is it possible for those who want a review of their files to get a review if they are willing to forgo or at least the check?

Mr. CURRY. That is not an element of the settlement that we reached.

Senator MENENDEZ. So the bottom line is that they will be foreclosed from a review?

Mr. CURRY. No. Part of the settlement is—and this was the impetus for having the $5.7 billion worth of assistance for foreclosure relief as part of the settlement. We have made it clear that those funds should be prioritized and that they should be directed toward the in-scope population and toward those individuals with the greatest risk of foreclosure. We want people to stay in their homes.

Senator MENENDEZ. Well, we want people to stay in their homes, too. The question is: What recourse do they have here other than pursuing their own litigation? They have none through your process. That is what I want to get to.

Mr. CURRY. The way the settlement is structured, we will try to allocate the payments to the most grievous situations. We have made——

Senator MENENDEZ. But you will not know that without a review of their files.

Mr. CURRY. We have done an analysis, a preliminary analysis of the level of harm in the total in-scope population. We think we have a fair estimate of overall who would be harmed. But we do recognize, as you stated, that certain individuals may not get fully compensated for financial harm.

Senator MENENDEZ. Well, we look forward to reviewing that with you further.

Last, Secretary Miller, the President called for something that both Senator Boxer and I have promoted and offered, the Responsibility Homeowners Refinancing Act and said it is past time to do it. Could you tell the Committee the value to individuals as well as to the economy of permitting refinancing at this time?

Ms. MILLER. Thank you for that question. The population of homeowners who today are underwater on their mortgages—we know that is about 20 percent of all homeowners—who have not been able to refinance in a low- interest-rate environment is a missed opportunity, we think, to reach homeowners who should be able to benefit from the spread of a high- interest-rate loan that they may hold versus where rates are today. So we would very much support any assistance that you can provide to help reach that population.

We do have a program that is reaching homeowners whose mortgages happen to be held or guaranteed by the GSEs. It is called HARP. And we have seen very good take-up in the refinancing assistance we are providing to underwater loan holders in that population. But it is the other group of homeowners who do not have a mortgage held at the GSEs that have not been able to take advantage of this. So we think that it is a priority. It would be good for homeowners. It would be good for the mortgage market. It would be good for the economy.

Senator MENENDEZ. Thank you.

Chairman JOHNSON. Senator Coburn.

Senator COBURN. Mr. Chairman, thank you. I am glad to be on this Committee. I just one question. I will submit the rest of my questions for the record.

This is to Mr. Cordray. You mentioned in your testimony financial literacy and that needs to be approved. I wonder if you are aware of how many financial literacy programs the Congress has running right now.

Mr. CORDRAY. I could not tell you exactly, but I can tell you that, by law, I am the Vice Chair of the Financial Literacy Education Commission, and we are coordinating with other agencies. There are 15 or 20 other agencies, and it does feel to me that one of the issues has been a sort of piecemeal approach to this problem. We have been given substantial responsibilities as a new consumer agency in this area, and I would like to work both with the Congress and with our fellow agencies as we are doing through what is called the FLEC that I mentioned, and also with State and local officials.

When I was a county treasurer and then State treasurer in Ohio, we were able to get the legislature to change the law such that every high school student in Ohio now has to have personal finance education before they can graduate. That is something we used to do years ago through the home economics curriculum and like. I have seen mathematics textbooks from the teens and twenties where a lot of the questions asked were put in terms of household budgeting and the types of financial issues that were around particularly farming and other communities. I think that is something that we have lost. It is something that has weakened our society, and it is something that we need to focus on.

But I would agree with you. There is a very scattered and disparate approach right now, and it has not been optimal.

Senator COBURN. It is pretty ironic the Federal Government is teaching Americans about financial literacy given the state of our economic situation.

There are 56 different Federal Government programs for financial literacy, and so what I would hope you would do in your position is really analyze this and make a recommendation to Congress after looking at the GAO report on this and tell us to get rid of them or get one, but not 56 sets of administrators, offices, rules, and complications and requirements that have to be fulfilled by people to actually implement financial literacy.

Mr. CORDRAY. I appreciate the comment. I would be glad to follow up with you and work and think about this. As we coordinate with one another, that helps minimize some of the problem. We have worked with the FDIC, particularly on their Money Smart curriculum, which is a terrific curriculum. We do not need to be reinventing the wheel. We are working with them now on creating a new module for older Americans and seniors who face some specific issues. I am sure your office hears about them quite a bit, and I would be happy to work with you on that. And I agree with the thrust of your question.

Senator COBURN. My only point is that with 56, if we start another one or another two or three and do not change those, we are throwing money out the door.

Mr. CORDRAY. I would agree with that.

Senator COBURN. Thank you.

Chairman JOHNSON. Senator Brown.

Senator BROWN. Thank you, Chairman Johnson.

Governor Tarullo, I would like to talk to you for a moment. Three or four years ago, in 2009, you said, and I quote, “Limiting the size or interconnectedness of financial institutions was more a provocative idea than a proposal.” And you said that in the context that there were not particularly any well-developed ideas out there. And since then, as we have talked, I have introduced legislation to limit the nondeposit liabilities of any single institution relative to domestic GDP. I have worked with Senator Vitter on that proposal, and we are considering to see, I think, more bipartisan support.

Tell me how your thinking has evolved—your more recent statement seems like it has. Tell me how your thinking has evolved from 2009 and why that is.

Mr. TARULLO. You are absolutely right, Senator Brown. My observation back in 2009 was that people would say something like, "Break up the banks." But there was not a plan behind it that allowed people to make a judgment as to whether it would address the kind of problems in too big to fail and others we saw in the crisis, and what the costs associated with it would be.

As you say, since then a lot of people have generated a lot of plans, and I think they probably fall into three categories. The first category is really a variant on things we already do: strengthen the barriers between insured depository institutions and other parts of bank holding companies; make sure that some activities are not taking place in the banks; make sure that there is enough capital in the rest of the holding company, even if they get into trouble independently, do not just think in terms of protecting the IDI itself.

Interestingly, those are a big part of some of the European proposals like the Liikanen and Vickers proposals. As I say, to a considerable extent, the U.S. has already gone down that road, and indeed Dodd-Frank strengthened some of those provisions.

The second set of proposals is what I would characterize as a functional split, so saying that there are certain kinds of functions that cannot be done within a bank holding company. Obviously Glass-Steagall was exactly that kind of approach. It separated investment banking from commercial banking. And there are some proposals out like this now. They sort of vary. Some of them would allow underwriting but not market making. Others might say nothing at all other than commercial banking.

There are issues on both sides. On the one hand, we have to ask ourselves, if we did that, would it actually address the problem that led to the crisis. As Senator Johnson was indicating in his introductory remarks, it was the failure of Bear Stearns, a broker-dealer, not a bunch of IDIs or relationships with IDIs, that precipitated the acute phase of the crisis.

The second issue, obviously, is what would be lost. Are there valuable roles played when, for example, an underwriter also makes market in the securities which it underwrites? I think most people would conclude that there are.

The third kind of example is embodied in your legislation, and I think in some other proposals, which focuses on the point that I tried to make at the close of my introductory oral remarks—what I would think of as the unaddressed set of issues, the unaddressed set of issues of large amounts of short-term, nondeposit, runnable funding. And I think here—and speaking personally now—my view is that is the problem we need to address. I think your legislation takes one approach to addressing it, which is to try to cap the amount that any individual firm can have and thereby try to contain the risk of the amplification of a run.

There are other complementary ideas such as restricting the amounts based on different kinds of duration risk or having higher requirements if you have more than a certain amount.

There are even broader ideas such as placing uniform margins on any kind of securities lending, no matter who participates in them.

From my point of view, the importance of what you have done is to draw attention to that issue of short-term, nondeposit, runnable funding, and that is the one I think we should be debating in the context of too big to fail and in the context of our financial system more generally.

Senator BROWN. Thank you.

Mr. Chairman, if I could just make a couple of quick comments. One, we have seen since—and thank you for that evolution in your thinking and the way you explained it.

When Senator Kaufman and I first introduced that amendment on the floor in 2010, it had bipartisan support, but it obviously fell short. We have seen from columnists like George Will and a *Wall Street Journal* op-ed columnist and a number of others sort of across the political spectrum, including colleagues that are, you know, way more conservative than I am on this in this body come around to looking at this pretty favorably. So we have seen a lot of momentum, and I appreciate your thinking.

Second, I wanted to bring up really quickly, Mr. Chairman—and I will not end with a question. But last week, Governor, I received the Fed's response to a letter regarding the imposition of Basel III on insurance companies. Senator Johanns and I sent, with 22 of our colleagues last years, Senators Johnson and Crapo sent a letter yesterday to the Fed on the insurance issue. And you and other Fed officials have stated several times you believe the proposed rule adequately accommodates the business of insurance. We respectfully disagree. I will not ask for a response now, but we will work with you on that, if we could. Thank you.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Heller. And welcome to the Committee.

Senator HELLER. Thank you very much, Mr. Chairman, and to the Ranking Member, it will be a pleasure to serve with you, and thanks for making me part of this team. And I want to thank those who have testified today. I have a lot to learn. I guess there are two messages. This takes a team to solve these problems that we have today. And, two, I do have a lot to learn.

I want to concentrate my comments today more on consolidation. We have had massive consolidation in the banking industry in Nevada. I come from the State with the highest unemployment, highest foreclosures, highest bankruptcies, and I think the health of the banking industry reflects the health of the State in its current position.

From about a 30,000-feet level looking down at this, we only have 14 community banks left in Nevada. We only have 23 credit unions left in Nevada. Eighty-five percent of all deposits are now concentrated in large banks, and 31 percent of Nevadans are unbanked or under-banked, which is the highest percentage in the country. Our housing, as, Ms. Miller, you mentioned, underwater mortgages are about 20 percent nationwide; it is about 60 percent in Nevada. So we are in a tough situation here, and I am concerned about consolidation.

My question—I see a lot of you writing notes, and I appreciate that, but what does this consolidation do? How does it help Nevadans get these loans? If the small banks—one of you testified—I cannot remember which one it was—that 50 percent of the small loans to businesses, to home mortgages, to car loans come from these community banks. With the loss of community banks—and let me make one more point before I raise the question, and that is, the Banking Association feels in Nevada that if you have deposits of less than $1 billion, you are probably going away. Less than $1 billion. Do you agree with that statement? And, two, how does it help Nevada to have this lack of financial opportunities and to consolidate in this manner? Mr. Gruenberg.

Mr. GRUENBERG. Yes, thank you, Senator. Just on the final point you made in terms of needing a certain level of deposits or assets to be viable in the banking system, this is actually one of the issues we did look at in the study we did looking at the experience of community banks over the past 27 years. And we tried to look closely at that particular issue because there is a lot of talk about that issue. And for what it is worth, based on the data that we analyzed, we could not find any significant economies of scale once you get over $300 million in assets. So the notion that a community bank has to be at least $1 billion in assets, for example, in order to be viable in the banking market was not proved out by the analysis we did.

You raise important points in regard to Nevada's particular situation. Nationally, Nevada had rapid expansion in commercial real estate, and that is what really, I think, drove a lot of the developments there. Hopefully Nevada has worked through the worst of that. That was not typical of the rest of the country, so I think it is fair to say Nevada was particularly impacted there.

I think for the surviving banks, one, it is a tribute to the work they did to manage their way through this, and I think it is fair to say they are deserving of particular attention and support going forward, given the role that community banks play in terms of credit availability. That was the point I made earlier. That is important because the particular niche for small banks, as you know, is small business lending, which tends to be labor intensive and highly customized. It is the sort of lending that the large institutions—who are interested in standardized products that they can offer in volume—are not necessarily interested in providing. So the community banks really have a critical role in filling that niche in the financial system.

Senator HELLER. Do you have a comment, Mr. Curry?

Mr. CURRY. Yes. I have been a community bank supervisor at the State and Federal level for 25 years, over 25 years, and I saw firsthand in New England the importance of community banks and their ability to help dig out of a severe recession. So I share your concerns and also your commitment to community banks.

I think as supervisors we can play a role in whether it is rulemaking or in the manner in which we actually supervise and examine these banks to eliminate unnecessary burden. It is something that we are committed to doing at the OCC where we have over 1,600 institutions. And the supervisory process I think for smaller banks, when the examiners talk to CEOs and lending officers, there is an actually an ability to share best practices and help improve the performance of community banks.

Senator HELLER. Thank you.

Mr. Chairman, thank you very much.

Chairman JOHNSON. Senator Warren.

Senator WARREN. Thank you very much, Mr. Chairman. Thank you, Ranking Member. It is good to be here. And thank you all for appearing. I have sat where you sit. It is harder than it looks. I appreciate your being here.

I want to ask a question about supervising big banks when they break the law, including the mortgage foreclosures but others as well. You know, we all understand why settlements are important, that trials are expensive and we cannot dedicate huge resources to them. But we also understand that if a party is unwilling to go to trial, either because they are too timid or because they lack resources, the consequence is they have a lot less leverage in all the settlements that occur.

Now, I know there have been some landmark settlements, but we face some very special issues with big financial institutions. If they can break the law and drag in billions in profits and then turn around and settle, paying out of those profits, they do not have much incentive to follow the law.

It is also the case that every time there is a settlement and not a trial, it means that we did not have those days and days and days of testimony about what those financial institutions had been up to.

So the question I really want to ask is about how tough you are about how much leverage you really have in these settlements. And what I would like to know is tell me a little bit about the last few times you have taken the biggest financial institutions on Wall Street all the way to a trial.

[Applause.]

Senator WARREN. Anybody? Chairman Curry?

Mr. CURRY. I would like to offer my perspective as a bank supervisor.

Senator WARREN. Sure.

Mr. CURRY. We primarily view the tools that we have as mechanisms for correcting deficiencies, so the primary motive for our enforcement actions is really to identify the problem and then demand a solution to it on an ongoing basis.

Senator WARREN. That is right. And then you set a price for that. I am sorry to interrupt, but I just want to move this along. It is effectively a settlement. And what I am asking is: When did you last take—and I know you have not been there forever, so I am really asking about the OCC—a large financial institution, a Wall Street bank to trial?

Mr. CURRY. Well, the institutions I supervise, national banks and Federal thrifts, we have actually had a fair number of consent orders. We do not have to bring people to trial or——

Senator WARREN. Well, I appreciate that you say you do not have to bring them to trial. My question is: When did you bring them to trial?

Mr. CURRY. We have not had to do it as a practical matter to achieve our supervisory goals.

Senator WARREN. Ms. Walter.

Ms. WALTER. Thank you, Senator. As you know, among our remedies are penalties, but the penalties we can get are limited, and my predecessor actually asked for additional authority to raise penalties. When we look at these issues—and we truly believe that we have a very vigorous enforcement program—we look at the distinction between what we could get if we go to trial and what we could get if we do not.

Senator WARREN. I appreciate that. That is what everybody does. And so the question I am really asking is: Can you identify when you last took the Wall Street banks to trial?

Ms. WALTER. I will have to get back to you with the specific information, but we do litigate, and we do have settlements that are either rejected by the Commission or not put forward for approval.

Senator WARREN. OK. We have got multiple people here. Anyone else want to tell me about the last time you took a Wall Street bank to trial?

You know, I just want to note on this, there are district attorneys and U.S. Attorneys who are out there every day squeezing ordinary citizens on sometimes very thin grounds and taking them to trial in order to "make an example," as they put it. I am really concerned that "too big to fail" has become "too big for trial." That just seems wrong to me.

[Applause.]

Senator WARREN. If I can—and I will go quickly, Chairman Johnson—I have one more question I would like to ask, and that is a question about why the large banks are trading at below book value. We all understand that book value is just what the assets are listed for, what the liabilities are and that most big corporations trade well above book value. But many of the Wall Street banks right now are trading below book value, and I can only think of two reasons why that would be so.

One would be because nobody believes that the banks' books are honest, or the second would be that nobody believes that the banks are really manageable—that is, that they are too complex either for their own institutions to manage them or for the regulators to manage them.

And so the question I have is: What reassurance can you give that these large Wall Street banks that are trading for below book value, in fact, are adequately transparent and adequately managed? Governor Tarullo or Ms. Miller.

Mr. TARULLO. There is certainly another reason we might add to your list, Senator Warren, which is investor skepticism as to whether a firm is going to make a return on equity that is in excess of what the investor regards as the value of the individual parts. And so I think what you would hear analysts say is that in the wake of the crisis, there have been issues on just that point surrounding, first, what the regulatory environment is going to be, how much capital is going to be required, what activities are going to be restricted, what are not going to be restricted.

Two, for some time there have been questions about the franchise value of some of these institutions. You know, the crisis showed that some of the so-called synergies were not very synergistic at all and, in fact, there really was not the potential, at least on a sustainable basis, to make a lot of money.

Part of it is probably just the environment of economic uncertainty.

In some cases, we have seen some effort to get rid of large amounts of assets at some of the large institutions. It is indirectly in response to just this point that some of them have concluded that they are not in a position to have a viable, manageable, profitable franchise if they have got all of the entities that they had before. And so a couple of them, as I say, have actually reduced or are in the process of reducing their balance sheets.

The other thing I would note is you are absolutely right about the difference there. The difference actually is that the economy has been improving and some of the firms have built up their capital. You have seen that difference actually narrowing in a number of cases as they seem to have a better position in the view of the market from which to proceed in a more feasible fashion.

Senator WARREN. Good. Well, I appreciate it, and I apologize for going over, Mr. Chairman. Thank you.

Chairman JOHNSON. Senator Hagan.

Senator HAGAN. Thank you, Mr. Chairman. Chairman Johnson, I appreciate your comments on QRM earlier.

For the U.S. housing market to continue on its path to recovery, consumers, lenders, and investors need clarity regarding the boundaries of mortgage lending. The recent action by the Consumer Financial Protection Bureau to finalize rules implementing the ability to repay provisions of Dodd-Frank was, I think, an important step toward certainty and access. Now that the CFPB has successfully finalized its work on the qualified mortgage definition, I urge you to work quickly to finalize the QRM definition in a way that ensures responsible borrowers have ongoing access to prudent, sustainable mortgages that for decades have been the cornerstone of a stable and strong U.S. housing market.

Earlier this week, we saw data showing that home loans that would be exempt from the ability-to-repay requirements and the proposed risk retention standard, even with a 10-percent downpayment requirement, made up less than half the market in 2010. Importantly, it should be noted that these loans rarely went into default.

Now that QM is finalized, can you assure me that your agencies will work diligently to complete a QRM rule in a manner consistent with that legislative intent? I would love your thoughts.

Mr. CURRY. Senator Hagan, we view the QRM rulemaking, the risk retention rulemaking process as an important one. With QM in place, we are looking forward to adopt an appropriate regulation as quickly as possible.

Senator HAGAN. "As quickly as possible" is defined as when?

Mr. CURRY. I think Governor Tarullo mentioned earlier we expect to wrap up most of the Dodd-Frank rulemaking this year.

Mr. TARULLO. Oh, I would hope on that one it would be sooner than the end of the year.

Senator HAGAN. The sooner the better.

Mr. TARULLO. Because the QM coming out, Senator, really now does allow us to go and finish it. Most of the other issues—the way these processes work is at a staff level people go through all the various issues and they try to either work them through or present them to their commissioners or Governors for resolution. There, most of that process has already proceeded, so there are a couple of things that are going to have to be considered by the people at this table and our colleagues in our various agencies. But it really was having QM final which lets us now go to completion.

Senator HAGAN. Under Secretary Miller, at the request of the Financial Stability Oversight Council (FSOC), the Office of Financial Research has been studying the asset management industry. This study is intended to help the FSOC to determine what risks, if any, this industry might pose to the U.S. financial system and whether any such risks are best addressed through designation of asset managers as nonbank systemically important financial institutions.

My question is: Can you talk about the transparency of the process? Will the results of the analysis be made public? And, will interested parties be provided the opportunity to comment formally on the results?

Ms. MILLER. Thank you. As you are aware, the FSOC has some responsibilities to designate nonbank financial institutions. In the course of doing that, in April of 2012 we published some criteria for exactly how that activity would proceed. At the time, we said that asset managers are large financial institutions, but they appeared different than some of the other financial institutions we were looking at, and we took that off the table to go off and do some additional work.

So the OFR has been doing that work, has been working with the market participants as well as members of the FSOC to complete that. I expect that if there is a plan to go forward with designation on an asset manager or an activity of an asset manager, there would have to be further publication of the criteria for doing that and the terms on which that would be considered. So we have been clear that we would be transparent and public about that.

Senator HAGAN. When you said you "took it off the table," what did you mean by that?

Ms. MILLER. We meant that we set it aside from the criteria that were established at the time for nonbank financial institutions to say that we wanted to study the asset management industry further to learn more about the activities and risks that they might present.

Senator HAGAN. Will the FSOC provide the public with an opportunity to comment on any metrics and thresholds relating to the potential designation of asset management companies as nonbank systemically important financial institutions—if you went to the point—prior to any designation of such a company?

Ms. MILLER. Well, I cannot speak for all the members of the FSOC and what they would want to do, but I think that that would be a reasonable course if we move forward in that direction.

Senator HAGAN. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Manchin.

Senator MANCHIN. Thank you, Mr. Chairman. First, I want to start by saying how excited I am about being a new Member of the Senate Banking Committee with all my colleagues, and I look forward to working with you all. And I want to thank both you, Chairman Johnson, and Ranking Member Crapo, my good friend, for allowing me to be part of this.

I would like to start out by saying that in West Virginia we have a lot of community banks that have been basically really stable and done a good job, but they are caught up in this, if you will, the whole banking changes and regulations. And with that being said, I know there have been some things that have helped by the Dodd-Frank, but I think most of the community banks believe that it has been very onerous on them.

Federal Reserve Board Governor Elizabeth Duke recently gave a speech in favor of the community banks where she said that a one-size-fits-all regulatory environment makes it difficult for community banks and that hiring compliance experts can put an enormous burden on small banks. She also went on to say that hiring one additional employee would reduce the return on assets by 23 basis points for many small banks. In other words, 13 percent of the banks with assets less than $50 million, these are the banks that did not cause this problem that we got into in 2008. But they have been lumped in with all the bad actors, if you will, and all the bad practices.

What we are saying on that—how are you all, because you all—if I look across this and me being brand new to the Committee, you pretty much have every aspect of regulations. How are you dealing with that? Anybody can start. Mr. Gensler.

Mr. GENSLER. Well, I would just say Congress gave us the authority to exempt what Congress said was small financial institutions, anything less than $10 billion in size, from the central clearing requirement. We went through a rulemaking, and we did just that. We exempted about 15,000 institutions from—we do not oversee the banks, but we did our share on the community banks.

Senator MANCHIN. The only thing I could say on that is that you could, but they are just saying to comply with the massive amount of paperwork regulations and the people they would have to hire to do that when they were not at fault. And I think every—they are saying this across the board.

Mr. GENSLER. Yes. I was just saying what the CFTC did. We just exempted them from the one provision that, you know, Congress gave us authority.

Senator MANCHIN. Anybody else? Anybody feel like exempting them?

Mr. CORDRAY. Senator, I would be happy to mention—so on the mortgage rules that we just completed, the qualified mortgage rule and our mortgage servicing rules are the most significant and substantive rules. We were convinced—as you say, and I have said it many times—that the smaller community banks and credit unions did not do the kinds of things that caused the crisis and, therefore, we should take account of that and protect their lending model as we now regulate to prevent the crisis from happening again.

On the servicing rules, we exempted smaller servicers from having to comply with big chunks of that rule in consultation with people. And on the qualified mortgage rule, we have done a reproposal that would allow smaller banks that keep loans in portfolios—many of them do—to be deemed qualified mortgages, and I think that that is quite important. It has been well received, and we are looking to finalize that proposal——

Senator MANCHIN. Thank you. Since my time is short, I would like to ask this question, and maybe the people who have not—Glass-Steagall was put in place in 1933 to prevent exactly what happened to us. It was in place, I think, for approximately 66 years until it was repealed. Up until the 1970s, it worked pretty well. We started seeing some changes and chipping away with new rules that took some powers away from Glass-Steagall. And then we finally repealed it in 1999, and the collapse in 2008.

How do you all—I mean, the Volcker Rule—and I know it does not do what the Glass-Steagall does, but why would we have those protections? And if it worked so well for so many years, why do you all not believe it is something we should return to or look at very—Governor.

Mr. TARULLO. Let me take a shot at that, Senator. I think you have put your finger on the time frame at which what had been a quite safe, pretty stable, not particularly innovative financial system began to change. One of the big reasons, though, it began to change was that commercial banks were facing increasing competition on both the asset and liability sides of their demand sheet—their balance sheet.

You had, on the one hand—and this is essentially a good development—the growth of capital markets——

Senator MANCHIN. Where was the competition coming from?

Mr. TARULLO. I was about to say the growth of public capital markets that were allowing more and more corporations to issue public debt, to issue bonds, so they did not rely as much on bank lending, borrowing from banks as they used to. And, on the other side, you saw the growth of savings vehicles like money market funds which provided higher returns than an insured deposit in one of those institutions. So the banks felt themselves squeezed on both sides by what in some respects were very benign, very good developments, which is to say more options for people. Where I think——

Senator MANCHIN. So we changed the rule basically to allow them to get into risky ventures.

Mr. TARULLO. Well, in some cases it was risky ventures, that is right. There definitely was a deregulatory movement in bank regulation beginning in about the mid-1970s for an extended period of time. And I guess what I would say is that it would—if I had to identify a collective mistake by the country as a whole, it was not in trying to preserve a set of rules and structures which were just being eroded by everything that was going on in the unregulated sector. I would say the mistake lay in not substituting a new, more robust set of structures and measures that could take account of the intertwining of conventional lending with capital markets. And that process of pulling away old regulation but not putting in place new modernized responsive regulation, I think that is what left us vulnerable.

Senator MANCHIN. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman. I want to thank the Ranking Member and you for your service on this Committee, and I look forward to working with you both on issues of consequence here. And I want to thank everybody that is on the Committee.

I am going to start out with some questions to Chairman Walter, if I might. Investor protection was clearly one of the most significant issues contemplated by Dodd-Frank, including direction to the SEC to examine the standards of care for broker-dealers and investor advisers in providing investor advice. The SEC released a study on the subject that recommended that the Commission exercise its rulemaking authority to implement uniform fiduciary standards while preserving investor choice.

It has been 2 years since that study was released. In your testimony, you mentioned that the SEC is drafting a public request for information to gather more data regarding this provision.

I guess, first of all, do you anticipate the SEC will move forward on this issue? And when?

Ms. WALTER. I expect that the request for comment that is referenced in my testimony will go out in the near future, in the next month or two.

Senator TESTER. OK.

Ms. WALTER. With respect to the substance of the issue, speaking only for myself, I would love to move forward on this issue as soon as possible. Opinions at the Commission vary a great deal in terms of the potential costs it imposes. My own personal view is that it is the right thing to do and we should proceed, and that we should then go on or perhaps at the same time take a very hard look—and there is, I think, more support for this at the Commission—at the different rules that are applicable to the two different professions, the investment adviser and the broker-dealer professions, to see where they should be harmonized and where, in fact, the differences in the regulatory structures are justified.

Senator TESTER. Well, first of all, I appreciate your position on this issue. I would encourage the Commissioners to make this a priority because I think there is absolute benefit to investors. And if you can help push it. I do not speak for the Chairman of Ranking Member, but if we find it as a priority, maybe we can help push it. But I think it is very, very important.

Ms. WALTER. I appreciate that, and I agree with you completely.

Senator TESTER. Thank you.

Another question deals with the JOBS Act that was signed about 10 months ago, and a few of those provisions were effective immediately. The SEC has really blown by most of the statutory deadlines for rulemaking and rules have yet to be proposed. The SEC I think put out one proposed rule on general solicitation in August with the comment period that closed in October. Since then, there has not been much talk about finalizing the rule or the rest of the rulemaking requested by that act.

I am troubled by rumblings that I have heard suggesting that implementation of the portion of the bill that the Commission has dubbed as “Regulation A Plus” may not be a priority for the SEC. And I appreciate you do have a lot on your plate—I understand that—in the way of rulemaking. But we need the SEC to make progress so that small businesses that this law was intended to benefit can better access capital markets.

Can you outline the Commission’s timeline for JOBS Act implementation including Regulation A Plus, including when you anticipate the SEC staff will present draft rules to the Commissioners?

Ms. WALTER. Our rulemaking priorities start with Dodd-Frank and the JOBS Act, and then beyond that we see what else we can accomplish at the same time. So we are looking very closely now, particularly in how to proceed with the general solicitation provisions of the law, which received rather interesting and divided comment. We have to make a decision as to whether to proceed with lifting the ban on general solicitation in a stark way or whether to accompany it with a number of protections that were offered by various commenters, including unanimously by our Investor Advisory Committee with respect to suggestions as to how to implement with additional investor protections. That is actively at the top of our plate right now.

Following closely behind that, we are working in the next few months on putting together a crowdfunding proposal. I will say, although we very much regret not meeting the statutory deadlines, we have learned a lot by meeting with people both from this country and from abroad who have engaged actively in crowdfunding in the securities sphere, and I think that will help to illuminate our proposal and to make it the best proposal that it can be.

Senator TESTER. Well, I just have to say, the JOBS Act was said by some to be the most important jobs bill that we have done in a while as far as actually creating jobs. I can tell you, in my State of Montana, which is incredibly rural, folks are hungry to get going. And I think we are holding the process up. And like I said, I know you are pushed in a lot of different directions and you are very, very busy, but I would certainly hope that, once again, we can get some things out very, very quickly, because I do not think we get the full benefit of the act until we do.

And I assume since I am the last questioner I can just keep going, right, Mr. Chairman?

[Laughter.]

Chairman JOHNSON. No.

Senator TESTER. I have more questions, but I just want to say thank you all for what you do, and just because I did not ask you a question does not mean I do not still love you.

[Laughter.]

Senator TESTER. Thank you.

Chairman JOHNSON. Thank you all for your testimony and for being here with us today. I appreciate your hard work in implementing those implement reforms.

Also, Senator Crapo has additional questions he would like to submit.

This hearing is adjourned.

[Whereupon, at 12:33 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR HEIDI HEITKAMP

Chairman Johnson and Ranking Member Crapo, thank you for holding this important hearing, and thank you to our many witnesses for appearing today. I look forward to working with all of you as a Member of this Committee.

After spending the last year traveling across North Dakota and talking with community banks and credit unions across my great State, it is clear that small financial institutions are struggling. As active members in their communities, they provide crucial services in rural communities and underserved areas. Yet, burdensome and complicated regulation is contributing to an environment where the cost of business is overwhelming and consolidation is too often the answer.

I applaud the efforts of some regulators to work with the community banking industry to ensure the industry is strong and their regulation is efficient and effective. We must encourage this trend to continue and facilitate a dialogue to ensure smaller institutions are not adversely affected by regulations targeted at large, complex ones. We must create a banking system that supports community banks and credit unions rather than stymies their ability to thrive.

As more rules are finalized to work toward financial stability and increase investor and consumer protections, I look forward to working with the appropriate regulators to make sure our smaller financial institutions receive the consideration they deserve and can continue to serve the many communities in North Dakota that rely on their services.

PREPARED STATEMENT OF MARY J. MILLER

UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

FEBRUARY 14, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to appear here today to discuss progress implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act.

The Dodd-Frank Act represents the most comprehensive set of reforms to the financial system since the Great Depression. The package of reforms President Obama signed into law 2½ years ago was a needed antidote for regulations that were too antiquated and weak to prevent or respond effectively to a financial crisis that inflicted devastating damage on the U.S. economy and American families. The inadequacy of our previous financial regulatory system was a major reason the crisis was so severe and why the recovery has taken so long.

Americans are already beginning to see benefits of the reforms implemented in the wake of the crisis reflected in a safer and stronger financial system and a broader economic recovery. Although the financial markets have recovered more vigorously than the overall economy, with the stock market near its October 2007 all-time high, the economic recovery is gaining traction. Private-sector payrolls have increased by more than 6 million jobs from the low point in February 2010, marking the 35th consecutive month of private-sector job growth. The unemployment rate, while still too high at 7.9 percent, has fallen more than two percentage points since its October 2009 peak of 10.0 percent. The recovery in the housing market also still has further to go, but it appears to be taking firmer hold as measured by rising home prices, stronger sales, and declining numbers of delinquencies and defaults.

The financial regulators represented here today have been making significant progress implementing Dodd-Frank Act reforms. Consumers have access to better information about financial products and are benefiting from new protections. Financial markets and companies have become more transparent. Regulators have become better equipped to monitor, mitigate, and respond to threats to the financial system.

Our financial system has also become smaller as a share of the economy and significantly less leveraged, reducing our vulnerability to a future crisis. Capital requirements for the largest banks have increased substantially, and U.S. banks have raised their capital levels to approximately $1 trillion, up 75 percent from 3 years ago. We have a new framework in place for protecting the financial system, the economy, and taxpayers from the consequences of the failure of a large financial company.

Eleven of the largest bank holding companies have already submitted their living wills to the Federal Reserve and Federal Deposit Insurance Corporation, and the other firms required to submit living wills will follow suit by the end of this year, providing their regulators with a roadmap to wind them down should they fail. The costs of resolving a failed financial company will not be borne by taxpayers, but by the company's stockholders, creditors, and culpable management—and if necessary by the financial services industry.

The newly created Consumer Financial Protection Bureau (CFPB) has taken important steps to provide clarity on consumer financial products for ordinary Americans. The CFPB is cracking down on abusive practices and helping to level the playing field between banks and nonbanks, so that they play by the same rules when dealing with customers.

Expanded enforcement authorities at the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), along with their new whistleblower rules, are providing investors with increased protections, and the agencies' vigorous enforcement efforts should serve as a greater deterrent to misconduct. Investors in thousands of publicly traded companies have exercised new rights to vote on executive compensation packages as a result of Dodd-Frank's say-on-pay provisions.

A new framework for regulatory oversight of the over-the-counter (OTC) derivatives market is largely in place. It will significantly reduce the risks associated with these products and will provide much-needed transparency for both market participants and regulators. As a result of trade-reporting requirements, the price and volume of certain swap transactions are now available to regulators and the public, at no charge, and reporting for additional asset classes will begin at the end of this month. Swap dealers now have to register with the CFTC and adhere to new standards for business conduct and record keeping. Beginning next month, certain types of financial institutions transacting in clearable interest-rate or credit-index swaps must move those transactions to central clearinghouses, reducing overall risk to the financial system.

Treasury's responsibilities under the Dodd-Frank Act include standing up new organizations to strengthen coordination of financial regulation both domestically and internationally, improve information sharing, and better identify and respond to potential risks to the financial system. Over the past 30 months, we have focused considerable effort on creating the Financial Stability Oversight Council, the Office of Financial Research, and the Federal Insurance Office and making them effective and efficient organizations that fulfill the objectives established in the Dodd-Frank Act.

The Financial Stability Oversight Council

The Financial Stability Oversight Council (FSOC) has become a valuable forum for collaboration among financial regulators and, despite its relative youth, has become a central figure in the implementation of financial regulatory reform and in addressing risks to the financial system.

Although FSOC members by law are required to meet only quarterly, the FSOC has been far more active than that. In 2012, FSOC principals met 12 times to conduct their regular business and respond to specific market developments. Additionally, the FSOC facilitates significant collaboration and information-sharing at the staff level through regular meetings of its Deputies Committee, which meets on a bi-weekly basis, and its Systemic Risk Committee, which meets monthly.

These are key forums for coordination among regulators. There is steady and understandable demand from the financial industry for enhanced regulatory coordination. Given the different statutory mandates and supervisory responsibilities of the various independent financial regulators, they are not always able to achieve as much alignment as regulated entities and market participants might desire. However, by having a regular forum available for frank discussion and early identification of areas of mutual or potentially overlapping interests, the financial regulatory community has been able to better identify issues that would benefit from enhanced coordination. On the international front, for example, the U.S. representatives to groups such as the Financial Stability Board and the International Association of Insurance Supervisors are able to use the FSOC as a means of sharing information and collaborating with a broader group of domestic colleagues on international efforts.

The benefits of strengthened coordination go beyond regulatory implementation. One of the strongest attributes of the FSOC has been its ability to quickly bring the key regulators together to respond to events such as the failure of MF Global and the disruption to financial markets caused by Superstorm Sandy.

In addition to the FSOC's coordination role, it has certain authority to provide for more stringent regulation of a financial activity by issuing recommendations to the responsible regulatory agencies. An example along these lines is vulnerability in the short-term funding markets, which the FSOC first addressed in its 2011 annual report and then again in 2012. The focus on this exposure ultimately led to the FSOC's issuance for public comment of proposed recommendations on money market mutual fund reforms. The comment period on those proposed recommendations closes tomorrow, February 15.

The FSOC has also taken significant steps to designate and increase oversight of financial companies whose failure or distress could negatively impact financial markets or the financial stability of the United States. In July 2012, the FSOC designated eight financial market utilities, companies that play important roles in our clearing, payment, and settlement systems, as systemically important. These companies are now subject to higher risk-management standards and coordinated oversight by the Federal Reserve, the SEC, and the CFTC. The FSOC is also in the final stages of evaluating an initial set of nonbank financial companies for potential designation, and completing that work is an important priority for 2013. Designated nonbank financial companies will be subject to enhanced prudential standards and supervision by the Federal Reserve, closing an important regulatory gap.

The Office of Financial Research

Treasury has made significant progress in establishing the Office of Financial Research (OFR), which has been further strengthened with the confirmation of Richard Berner early this year as its first Director.

The OFR provides important support for the FSOC, including data for the FSOC annual report as well as data and analysis relating to the designation of nonbank financial companies. In collaboration with FSOC members, the OFR is also developing new dashboards of financial stability metrics and indicators for use by the FSOC's Systemic Risk Committee.

A key part of the OFR mission is to fill the gaps in existing data and analysis. The OFR has accordingly completed an initial inventory of purchased and collected data among FSOC member agencies and an inventory of internally developed data is underway. To improve the quality and scope of data available to policy makers, the OFR has established data-sharing agreements with a number of FSOC member agencies and continues to work on new ones as needed.

The OFR plays a leadership role in the international initiative to establish a global Legal Entity Identifier (LEI), a code that uniquely identifies parties to financial transactions. The OFR's chief counsel was recently named Chair of the LEI Regulatory Oversight Committee. With the planned launch of the global system next month, the goal of standardizing the identification of these entities will become a reality. Financial companies and financial regulators worldwide will gain a better view of true exposures and counterparty risks across the global financial system.

In July 2012, the OFR issued its first annual report assessing the state of the U.S. financial system, the status of the efforts by the OFR to meet its mission, and key findings of the OFR's research and analysis. We have also established the Financial Research Advisory Committee, composed of 30 distinguished professionals in economics, finance, financial services, data management, risk management, and information technology to provide advice and recommendations to the OFR.

Federal Insurance Office

Treasury has also worked to establish the Federal Insurance Office (FIO) and develop its ability to serve as the Federal voice on insurance issues, both domestically and internationally.

FIO is responsible for monitoring all aspects of the insurance industry, including identifying issues or gaps in regulation that could contribute to a systemic crisis in the insurance industry or financial system. FIO coordinates and develops Federal policy on prudential aspects of international insurance matters; represents the United States at the International Association of Insurance Supervisors (IAIS); and, along with the independent insurance expert and a State insurance commissioner, the FIO Director contributes insurance expertise to the FSOC as a nonvoting member. FIO also monitors the accessibility and affordability of nonhealth insurance products to traditionally underserved communities.

Until the establishment of FIO, the United States was not represented by a single, unified Federal voice in the development of international insurance supervisory standards. FIO now provides important leadership in developing international insurance policy. In 2012, FIO was elected to serve on the IAIS Executive Committee and as Chair of its Technical Committee. FIO is involved with the IAIS's development of the methodology to identify global systemically important insurers and the policy measures to be applied to any designated firm. Apart from its work with the IAIS, FIO established and has provided leadership in the European Union–United States insurance project regarding matters such as group supervision, capital requirements, reinsurance, and financial reporting. FIO has worked and will continue to work closely and consult with State insurance regulators and other Federal agencies in this work.

FIO will soon release its first annual report on the insurance industry and its report on how to modernize and improve the system of insurance regulation in the United States. FIO is working diligently to release these and several other reports in the coming months.

Coordination

In the year ahead, Treasury will continue to build on the FSOC's existing strengths as a key forum for information-sharing and collaboration among regulators and continue to develop the expertise and capacity of the OFR and FIO.

Although we are not a rulemaking agency for either the Dodd-Frank Act's Volcker Rule or risk-retention rule, the Treasury Secretary, in his capacity as Chairperson of the FSOC, has an explicit statutory coordination role with respect to both of those rulemakings. We take that role very seriously and will continue to work with the respective rulemaking agencies as they finalize those rules.

Another area where we continue to engage in significant coordination with other agencies is with respect to the Dodd-Frank Act's new orderly liquidation authority. We have participated in extensive planning exercises and preparations with the Federal Reserve and FDIC to be fully prepared to wind down a company whose failure could have serious adverse effects on U.S. financial stability.

International

Our progress on domestic implementation is mirrored by our work internationally to support efforts to make financial regulations more consistent worldwide through the G20 and the Financial Stability Board (FSB). By moving early with the passage and implementation of the Dodd-Frank Act, we have been able to lead from a position of strength in setting the international reform agenda and elevating the world's standards to our own. We remain attentive to the inevitable inconsistencies and lags on implementation and continue to emphasize that successful implementation of global financial regulatory reforms is essential for promoting U.S. financial sector competitiveness; building a stable, secure, and more resilient financial system; and avoiding regulatory arbitrage and a race to the bottom.

We are pursuing a comprehensive reform agenda internationally spanning bank capital and liquidity, resolution, and OTC derivatives markets.

On capital and liquidity, the Basel III standards raise the quality and quantity of capital and strengthen liquidity requirements so that banks can better protect themselves against losses of the magnitude seen in the crisis. These form the bulwark of core reforms that will enhance the stability of the international banking system. In June 2012, the Federal banking agencies issued proposed rules and currently are working to adopt final rules to implement the Basel III standards in 2013. It is critical that our international partners implement Basel III faithfully as soon as possible. In fact, the majority of the largest U.S. banks already meet Basel III capital targets—well ahead of schedule.

On resolution, we have reached an important agreement that key financial jurisdictions should have the tools to resolve large cross-border financial firms without the risk of severe disruption or taxpayer exposure to loss. The FSB is working actively to see that this international commitment by regulators will drive major global banks to develop cross-border recovery and resolution plans; develop criteria to improve the "resolvability" of systemically important institutions; and negotiate institution-specific cross-border resolution cooperation arrangements.

On derivatives, U.S. regulators have led with implementation of reforms to centrally clear derivatives and require transaction reporting. We have also led the call for the development of a global margin standard for OTC derivatives that are not centrally cleared, and the G20 and the FSB are making steady progress in their efforts to develop such a standard.

We have made real progress internationally on all of these fronts and must continue to do so. As the global economy heals from the devastation of the crisis, the urgency for reform may wane. Progress remains uneven internationally and significant work remains. We must redouble efforts domestically and urge our partners internationally to continue this essential work. In particular, we must be careful to avoid a fragmentation in financial regulation internationally, which can lead to uneven regulation, unequal treatment, constrained capital flows, and increased uncertainty. Treasury will continue to work with our partners around the world to achieve global regulatory convergence.

Conclusion

Financial regulatory reform implementation has presented one of the most challenging sets of responsibilities for regulators in nearly 80 years. We have a highly complex, international financial system with many intricately linked parts. While the demand for simple rules has a superficial appeal, simple rules do not suffice to address the nuances of a complex financial system. Also, as the work of regulatory reform implementation proceeds, issues inevitably arise such as MF Global's failure, the so-called "London Whale" trading losses, and LIBOR manipulation that inform the work of regulators in important ways but that also require significant attention in and of themselves.

As we move forward, it is critical to strike the appropriate balance of measures to protect the strength and stability of the U.S. financial system while preserving liquid and efficient markets that promote access to capital and economic growth. Rules must also be properly calibrated to risks, taking into account, for example, the reduced risks that community banks pose compared to large, complex financial institutions.

Finally, we cannot afford to succumb to complacency now as the financial markets and economy slowly continue to recover. Efforts to repeal the Dodd-Frank Act in whole or piecemeal or to starve regulators by underfunding them will hamper growth, allow uncertainty to fester, and be corrosive to the strength and stability of our financial system. The progress we have made so far is because of the reforms that we are putting in place, not in spite of them. Completion of these reforms provides the best path to building a sounder foundation for continued economic growth and prosperity.

PREPARED STATEMENT OF DANIEL K. TARULLO

GOVERNOR, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

FEBRUARY 14, 2013

Chairman Johnson, Ranking Member Crapo, and other Members of the Committee, thank you for the opportunity to testify on implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). In today's testimony, I will provide an update on the Federal Reserve's recent activities pertinent to the Dodd-Frank Act and describe our regulatory and supervisory priorities for 2013.

The Federal Reserve, in many cases jointly with other regulatory agencies, has made steady and considerable progress in implementing the Congressional mandates in the Dodd-Frank Act, though obviously some work remains. Throughout this effort, the Federal Reserve has maintained a focus on financial stability. In the process of rule development, we have placed particular emphasis on mitigating systemic risks. Thus, among other things, we have proposed varying the application of the Dodd-Frank Act's special prudential rules based on the relative size and complexity of regulated financial firms. This focus on systemic risk is also reflected in our increasingly systematic supervision of the largest banking firms.

Recent Regulatory Reform Milestones

Strong bank capital requirements, while not alone sufficient to guarantee the safety and soundness of our banking system, are central to promoting the resiliency of banking firms and the financial sector as a whole. Capital provides a cushion to absorb a firm's expected and unexpected losses, helping to ensure that those losses are borne by shareholders rather than taxpayers. The financial crisis revealed, however, that the regulatory capital requirements for banking firms were not sufficiently robust. It also confirmed that no single capital measure adequately captures a banking firm's risks of credit and trading losses. A good bit of progress has now been made in strengthening and updating traditional capital requirements, as well as devising some complementary measures for larger firms.

As you know, in December 2010 the Basel Committee on Banking Supervision (Basel Committee) issued the Basel III package of reforms to its framework for minimum capital requirements, supplementing an earlier set of changes that increased requirements for important classes of traded assets. Last summer, the Federal Reserve, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) issued for comment a set of proposals to implement the Basel III capital standards for all large, internationally active U.S. banking firms. In addition, the proposals would apply risk-based and leverage capital requirements to savings and loan holding companies for the first time. The proposals also would modernize and harmonize the existing regulatory capital standards for all U.S. banking firms, which have not been comprehensively updated since their introduction 25 years ago, and incorporate certain new legislative provisions, including elements of sections 171 and 939A of the Dodd-Frank Act.

To help ensure that all U.S. banking firms maintain strong capital positions, the Basel III proposals would introduce a new common equity capital requirement, raise the existing tier 1 capital minimum requirement, implement a capital conservation buffer on top of the regulatory minimums, and introduce a more risk-sensitive standardized approach for calculating risk-weighted assets. Large, internationally active banking firms also would be subject to a supplementary leverage ratio and a countercyclical capital buffer and would face higher capital requirements for derivatives and certain other capital markets exposures they hold. Taken together, these proposals should materially reduce the probability of failure of U.S. banking firms—particularly the probability of failure of the largest, most complex U.S. banking firms.

In October 2012, the Federal Reserve finalized rules implementing stress testing requirements under section 165 of the Dodd-Frank Act. Consistent with the statute, the rules require annual supervisory stress tests for bank holding companies with $50 billion or more in assets and any nonbank financial companies designated by the Financial Stability Oversight Council (Council). The rules also require company-run stress tests for a broader set of regulated financial firms that have $10 billion or more in assets. The new Dodd-Frank Act supervisory stress test requirements are generally consistent with the stress tests that the Federal Reserve has been conducting on the largest U.S. bank holding companies since the Supervisory Capital Assessment Program in the spring of 2009. The stress tests allow supervisors to assess whether firms have enough capital to weather a severe economic downturn and contribute to the Federal Reserve's ability to make assessments of the resilience of the U.S. banking system under adverse economic scenarios. The stress tests are an integral part of our capital plan requirement, which provides a structured way to make horizontal evaluations of the capital planning abilities of large banking firms.

The Federal Reserve also issued in December of last year a proposal to implement enhanced prudential standards and early remediation requirements for foreign banks under sections 165 and 166 of the Dodd-Frank Act. The proposal is generally consistent with the set of standards previously proposed for large U.S. bank holding companies. The proposal generally would require foreign banks with a large U.S. presence to organize their U.S. subsidiaries under a single intermediate holding company that would serve as a platform for consistent supervision and regulation. The U.S. intermediate holding companies of foreign banks would be subject to the same risk-based capital and leverage requirements as U.S. bank holding companies. In addition, U.S. intermediate holding companies and the U.S. branches and agencies of foreign banks with a large U.S. presence would be required to meet liquidity requirements similar to those applicable to large U.S. bank holding companies. The proposals respond to fundamental changes in the scope and scale of foreign bank activities in the United States in the last 15 years. They would increase the resiliency and resolvability of the U.S. operations of foreign banks, help protect U.S. financial stability, and promote competitive equity for all large banking firms operating in the United States. The comment period for this proposal closes at the end of March.

Priorities for 2013

The Federal Reserve's supervisory and regulatory program in 2013 will concentrate on four tasks: (1) continuing key Dodd-Frank Act and Basel III regulatory implementation work; (2) further developing systematic supervision of large banking firms; (3) improving the resolvability of large banking firms; and (4) reducing systemic risk in the shadow banking system.

Carrying Forward the Key Dodd-Frank Act and Basel III Regulatory Implementation Work

Capital, Liquidity, and Other Prudential Requirements for Large Banking Firms. Given the centrality of strong capital standards, a top priority this year will be to update the bank regulatory capital framework with a final rule implementing Basel III and the updated rules for standardized risk-weighted capital requirements. The banking agencies have received more than 2,000 comments on the Basel III capital proposal. Many of the comments have been directed at certain features of the proposed rule considered especially troubling by community and smaller regional banks, such as the new standardized risk weights for mortgages and the treatment of unrealized gains and losses on certain debt securities. These criticisms underscore the difficulty in fashioning standardized requirements applicable to all banks that balance risk sensitivity with the need to avoid excessive complexity. Here, though, I think there is a widespread view that the proposed rule erred on the side of too much complexity. The three banking agencies are carefully considering these and all comments received on the proposal and hope to finalize the rulemaking this spring.

The Federal Reserve also intends to work this year toward finalization of its proposals to implement the enhanced prudential standards and early remediation requirements for large banking firms under sections 165 and 166 of the Dodd-Frank Act. As part of this process, we intend to conduct shortly a quantitative impact study of the single-counterparty credit limits element of the proposal. Once finalized, these comprehensive standards will represent a core part of the new regulatory framework that mitigates risks posed by systemically important financial firms and offsets any benefits that these firms may gain from being perceived as "too big to fail."

We also anticipate issuing notices of some important proposed rulemakings this year. The Federal Reserve will be working to propose a risk-based capital surcharge applicable to systemically important banking firms. This rulemaking will implement for U.S. firms the approach to a systemic surcharge developed by the Basel Committee, which varies in magnitude based on the measure of each firm's systemic footprint. Following the passage of the Dodd-Frank Act, which called for enhanced capital standards for systemically important firms, the Federal Reserve joined with some other key regulators from around the world in successfully urging the Basel Committee to adopt a requirement of this sort for all firms of global systemic importance.

Another proposed rulemaking will cover implementation by the three Federal banking agencies of the recently completed Basel III quantitative liquidity requirements for large global banks. The financial crisis exposed defects in the liquidity risk management of large financial firms, especially those which relied heavily on short-term wholesale funding. These new requirements include the liquidity coverage ratio (LCR), which is designed to ensure that a firm has a sufficient amount of high quality liquid assets to withstand a severe standardized liquidity shock over a 30-day period. The Federal Reserve expects that the U.S. banking agencies will issue a proposal in 2013 to implement the LCR for large U.S. banking firms. The Basel III liquidity standards should materially improve the liquidity risk profiles of internationally active banks and will serve as a key element of the enhanced liquidity standards required under the Dodd-Frank Act.

Volcker Rule, Swaps Push-out, and Risk Retention. Section 619 of the Dodd-Frank Act, known as the "Volcker Rule," generally prohibits a banking entity from engaging in proprietary trading or acquiring an ownership interest in, sponsoring, or having certain relationships with a hedge fund or private equity fund. In October 2011, the Federal banking agencies and the Securities and Exchange Commission sought public comment on a proposal to implement the Volcker Rule. The Commodity Futures Trading Commission subsequently issued a substantially similar proposal. The rulemaking agencies have spent the past year carefully analyzing the nearly 19,000 public comments on the proposal and have made significant progress in crafting a final rule that is faithful to the language of the statute and maximizes bank safety and soundness and financial stability at the least cost to the liquidity of the financial markets, credit availability, and economic growth.

Section 716 of the Dodd-Frank Act generally prohibits the provision of Federal assistance, such as FDIC deposit insurance or Federal Reserve discount window credit, to swap dealers and major swap participants. The Federal Reserve is currently working with the OCC and the FDIC to develop a proposed rule that would provide clarity on how and when the section 716 requirements would apply to U.S. insured depository institutions and their affiliates and to U.S. branches of foreign banks. We expect to issue guidance on the implementation of section 716 before the July 21, 2013, effective date of the provision.

To implement the risk retention requirements in section 941 of the Dodd-Frank Act, the Federal Reserve, along with other Federal regulatory agencies, issued in March 2011 a proposal that generally would force securitization sponsors to retain at least 5 percent of the credit risk of the assets underlying a securitization. The agencies have reviewed the substantial volume of comments on the proposal and the definition of a qualified mortgage in the recent final "ability-to-pay" rule of the Consumer Financial Protection Bureau (CFPB). As you know, the CFPB's definition of qualified mortgage serves as the floor for the definition of exempt qualified residential mortgages in the risk retention framework. The agencies are working closely together to determine next steps in the risk retention rulemaking process, with a view toward crafting a definition of a qualified residential mortgage that is consistent with the language and purposes of the statute and helps ensure a resilient market for private-label mortgage-backed securities.

Improving Systematic Supervision of Large Banking Firms

Given the risks to financial stability exposed by the financial crisis, the Federal Reserve has reoriented its supervisory focus to look more broadly at systemic risks and has strengthened its microprudential supervision of large, complex banking firms. Within the Federal Reserve, the Large Institution Supervision Coordinating

Committee (LISCC) was set up to centralize the supervision of large banking firms and to facilitate the execution of horizontal, cross-firm analysis of such firms on a consistent basis. The LISCC includes senior staff from various divisions of the Board and from the Reserve Banks. It fosters interdisciplinary coordination, using quantitative methods to evaluate each firm individually, relative to other large firms, and as part of the financial system as a whole.

One major supervisory exercise conducted by the LISCC each year is a Comprehensive Capital Analysis and Review (CCAR) of the largest U.S. banking firms.[1] Building on supervisory work coming out of the crisis, CCAR was established to ensure that each of the largest U.S. bank holding companies (1) has rigorous, forward-looking capital planning processes that effectively account for the unique risks of the firm and (2) maintains sufficient capital to continue operations throughout times of economic and financial stress. CCAR, which uses the annual stress test as a key input, enables the Federal Reserve to make a coordinated, horizontal assessment of the resilience and capital planning abilities of the largest banking firms and, in doing so, creates closer linkage between microprudential and macroprudential supervision. Large bank supervision at the Federal Reserve will include more of these systematic, horizontal exercises.

Improving the Resolvability of Large Banking Firms

One important goal of postcrisis financial reform has been to counter too-big-to-fail perceptions by reducing the anticipated damage to the financial system and economy from the failure of a major financial firm. To this end, the Dodd-Frank Act created the Orderly Liquidation Authority (OLA), a mechanism designed to improve the prospects for an orderly resolution of a systemic financial firm, and required all large bank holding companies to develop, and submit to supervisors, resolution plans. Certain other countries that are home to large, globally active banking firms are working along roughly parallel lines. The Basel Committee and the Financial Stability Board have devoted considerable attention to the orderly resolution objective by developing new standards for statutory resolution frameworks, firm-specific resolution planning, and cross-border cooperation. Although much work remains to be done by all countries, the Dodd-Frank Act reforms have generally put the United States ahead of its global peers on the resolution front.

Since the passage of the Dodd-Frank Act, the FDIC has been developing a single-point-of-entry strategy for resolving systemic financial firms under the OLA. As explained by the FDIC, this strategy is intended to effect a creditor-funded holding company recapitalization of the failed financial firm, in which the critical operations of the firm continue, but shareholders and unsecured creditors absorb the losses, culpable management is removed, and taxpayers are protected. Key to the ability of the FDIC to execute this approach is the availability of sufficient amounts of unsecured long-term debt to supplement equity in providing loss absorption in a failed firm. In consultation with the FDIC, the Federal Reserve is considering the merits of a regulatory requirement that the largest, most complex U.S. banking firms maintain a minimum amount of long-term unsecured debt. A minimum long-term debt requirement could lend greater confidence that the combination of equity owners and long-term debt holders would be sufficient to bear all losses at the consolidated firm, thereby counteracting the moral hazard associated with taxpayer bailouts while avoiding disorderly failures.

Reducing Systemic Risk in the Shadow Banking System

Most of the reforms I have discussed are aimed at addressing systemic risk posed by regulated banking organizations, and all involve action the Federal Reserve can take under its current authorities. Important as these measures are, however, it is worth recalling that the trigger for the acute phase of the financial crisis was the rapid unwinding of large amounts of short-term funding that had been made available to firms not subject to consolidated prudential supervision. Today, although some of the most fragile investment vehicles and instruments that were involved in the precrisis shadow banking system have disappeared, nondeposit short-term funding remains significant. In some instances it involves prudentially regulated firms, directly or indirectly. In others it does not. The key condition of the so-called "shadow banking system" that makes it of systemic concern is its susceptibility to destabilizing funding runs, something that is more likely when the recipients of the short-term funding are highly leveraged, engage in substantial maturity transformation, or both.

Many of the key issues related to shadow banking and their potential solutions are still being debated domestically and internationally. U.S. and global regulators

[1] For more information, *see, www.federalreserve.gov/bankinforeg/ccar.htm.*

need to take a hard, comprehensive look at the systemic risks present in wholesale short-term funding markets. Analysis of the appropriate ways to address these vulnerabilities continues as a priority this year for the Federal Reserve. In the short term, though, there are several key steps that should be taken with respect to shadow banking to improve the resilience of our financial system.

First, the regulatory and public transparency of shadow banking markets, especially securities financing transactions, should be increased. Second, additional measures should be taken to reduce the risk of runs on money market mutual funds. The Council recently proposed a set of serious reform options to address the structural vulnerabilities in money market mutual funds.

Third, we should continue to push the private sector to reduce the risks in the settlement process for triparty repurchase agreements. Although an industry-led task force made some progress on these issues, the Federal Reserve concluded that important problems were not likely to be successfully addressed in this process and has been using supervisory authority over the past year to press for further and faster action by the clearing banks and the dealer affiliates of bank holding companies.[2] The amount of intraday credit being provided by the clearing banks in the triparty repo market has been reduced and is scheduled to be reduced much further in the coming years as a result of these efforts. But vulnerabilities in this market remain a concern, and addressing these vulnerabilities will require the cooperation of the broad array of participants in this market and their Federal regulators. The Federal Reserve will continue to report to Congress and publicly on progress made to address the risks in the triparty repo market.

In addition to these concrete steps to address concrete problems, regulators must continue to closely monitor the shadow banking sector and be wary of signs that excessive leverage and maturity transformation are developing outside of the banking system.

Conclusion

The financial regulatory architecture is stronger today than it was in the years leading up to the crisis, but considerable work remains to complete implementation of the Dodd-Frank Act and the postcrisis global financial reform program. Over the coming year, the Federal Reserve will be working with other U.S. financial regulatory agencies, and with foreign central banks and regulators, to propose and finalize a number of ongoing initiatives. In this endeavor, our goal is to preserve financial stability at the least cost to credit availability and economic growth. We are focused on the monitoring of emerging systemic risks, reducing the probability of failure of systemic financial firms, improving the resolvability of systemic financial firms, and building up buffers throughout the financial system to enable the system to absorb shocks.

As we take this work forward, it is important to remember that preventing a financial crisis is not an end in itself. Financial crises are profoundly debilitating to the economic well-being of the Nation.

Thank you for your attention. I would be pleased to answer any questions you might have.

PREPARED STATEMENT OF MARTIN J. GRUENBERG

CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

FEBRUARY 14, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to testify today on the Federal Deposit Insurance Corporation's (FDIC) efforts to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

The economic dislocations experienced in recent years, which far exceeded any since the 1930s, were the direct result of the financial crisis of 2007–08. The reforms enacted by Congress in the Dodd-Frank Act were aimed at addressing the causes of the crisis. The reforms included changes to the FDIC's deposit insurance program, a series of measures to curb excessive risk-taking at large, complex banks and nonbank financial companies and a mechanism for orderly resolution of large, nonbank financial companies.

The regulatory changes mandated by the Dodd-Frank Act require careful implementation to ensure they address the risks posed by the largest, most complex institutions while being sensitive to the impact on community banks that did not con-

[2] For additional information, *see, www.newyorkfed.org/banking/tpr_infr_reform.html*.

tribute significantly to the crisis. As implementation moves forward, the FDIC has been engaged as well in an extensive effort to better understand the forces driving long-term change among U.S. community banks and to solicit input from community bankers on these trends and on the regulatory process.

My testimony will address the impact of the Dodd-Frank Act on the restoration of the Deposit Insurance Fund (DIF), our efforts to carry out the requirement of the Act to develop the ability to resolve large, systemic financial institutions, and our progress on some of the key rulemakings. In addition, I will briefly discuss the results of our recent community banking initiative.

Condition of the FDIC Deposit Insurance Fund (DIF)

Restoring the DIF

The Dodd-Frank Act raised the minimum reserve ratio for the DIF from 1.15 percent of estimated insured deposits to 1.35 percent, and required that the reserve ratio reach 1.35 percent by September 30, 2020. The FDIC is currently operating under a DIF Restoration Plan that is designed to meet this deadline, and the DIF reserve ratio is recovering at a pace that remains on track under the Plan. As of September 30, 2012, the DIF reserve ratio stood at 0.35 percent of estimated insured deposits, up from 0.12 percent a year earlier. The fund balance has grown for 11 consecutive quarters, increasing to $25.2 billion at the end of the third quarter of 2012. Assessment revenue, fewer anticipated bank failures, and the transfer of fees previously set aside for the Temporary Liquidity Guarantee Program (TLGP) have helped to increase the fund balance.

Expiration of the Transaction Account Guarantee (TAG) Program

The Dodd-Frank Act provided temporary unlimited deposit insurance coverage for non- interest-bearing transaction accounts from December 31, 2010, through December 31, 2012. This unlimited coverage was available to all depositors, including consumers, businesses, and Government entities, as long as the accounts were truly non- interest bearing. As the TAG came to a conclusion, the FDIC worked closely with banks to ensure that they would continue to be able to meet their funding and liquidity needs after expiration of the program. Thus far, the transition away from this emergency program has proceeded smoothly.

Expiration of the Debt Guarantee Program

Although not established by the Dodd-Frank Act, another program created in response to the crisis, the Debt Guarantee Program (DGP), was established under emergency authority to provide an FDIC guarantee of certain newly issued senior unsecured debt. The program enabled financial institutions to meet their financing needs during a period of record high credit spreads and aided the successful return of the credit markets to near normalcy, despite the recession and slow economic recovery. By providing the ability to issue debt guaranteed by the FDIC, the DGP allowed institutions to extend maturities and obtain more stable unsecured funding.

As with the Dodd-Frank TAG program, the DGP came to a close at the end of 2012. One hundred twenty-two banks and other financial companies participated in the DGP, and the volume of guaranteed debt peaked in early 2009 at $345.8 billion. The FDIC collected $10.4 billion in fees and surcharges under the program. Ultimately, over $9.3 billion in fees collected under the DGP have been transferred to assist in the restoration of the DIF to its statutorily mandated reserve ratio of 1.35 percent of insured deposits.

Implementation of Title I "Living Wills"

In 2011, the FDIC and the Federal Reserve Board (FRB) jointly issued the basic rulemaking regarding resolution plans that systemically important financial institutions (SIFIs) are required to prepare—the so-called "living wills." The rule requires bank holding companies with total consolidated assets of $50 billion or more, and certain nonbank financial companies that the Financial Stability Oversight Council (FSOC) designates as systemic, to develop, maintain and periodically submit to the FDIC and the FRB resolution plans that are credible and that would enable these entities to be resolved under the Bankruptcy Code. Complementing this joint rulemaking, the FDIC also issued a rule requiring any FDIC-insured depository institution with assets over $50 billion to develop, maintain and periodically submit plans outlining how the FDIC could resolve the institution using the traditional resolution powers under the Federal Deposit Insurance Act.

The two resolution plan rulemakings are designed to work in tandem by covering the full range of business lines, legal entities and capital-structure combinations within a large financial firm. The rulemakings establish a schedule for staggered annual filings. On July 1, 2012, the first group of living wills, generally involving bank holding companies and foreign banking organizations with $250 billion or more in nonbank assets, was received. Banking organizations with less than $250 billion, but $100 billion or more, in assets will file by July 1 of this year, and all other banking organizations with assets over $50 billion will file by December 31.

The Dodd-Frank Act requires that at the end of this process these plans be credible and facilitate an orderly resolution of these firms under the Bankruptcy Code. In 2013, the 11 firms that submitted initial plans in 2012 will be expected to refine and clarify their submissions. The agencies expect the refined plans to focus on key issues and obstacles to an orderly resolution in bankruptcy including global cooperation and the risk of ring-fencing or other precipitous actions. To assess this potential risk, the firms will need to provide detailed, jurisdiction-by-jurisdiction analyses of the actions each would need to take in a resolution, as well as the discretionary actions or forbearances required to be taken by host authorities. Other key issues include the continuity of critical operations, particularly maintaining access to shared services and payment and clearing systems, the potential systemic consequences of counterparty actions, and global liquidity and funding with an emphasis on providing a detailed understanding of the firm's funding operations and flows.

Implementation of Title II Orderly Liquidation Authority

Coordination With Foreign Resolution Authorities

The FDIC has largely completed the rulemaking necessary to carry out its systemic resolution responsibilities under Title II of the Dodd-Frank Act. In July 2011, the FDIC Board approved a final rule implementing the Title II Orderly Liquidation Authority. This rulemaking addressed, among other things, the priority of claims and the treatment of similarly situated creditors.

The experience of the financial crisis highlighted the importance of coordinating resolution strategies across national jurisdictions. Section 210 of the Dodd-Frank Act expressly requires the FDIC to "coordinate, to the maximum extent possible" with appropriate foreign regulatory authorities in the event of the resolution of a covered financial company with cross-border operations. As we plan internally for such a resolution, the FDIC has continued to work on both multilateral and bilateral bases with our foreign counterparts in supervision and resolution. The aim is to promote cross-border cooperation and coordination associated with planning for an orderly resolution of a globally active, systemically important financial institution (G–SIFIs).

As part of our bilateral efforts, the FDIC and the Bank of England, in conjunction with the prudential regulators in our jurisdictions, have been working to develop contingency plans for the failure of G–SIFIs that have operations in both the U.S. and the U.K. Of the 28 G–SIFIs designated by the Financial Stability Board of the G20 countries, 4 are headquartered in the U.K., and another 8 are headquartered in the U.S. Moreover, around two-thirds of the reported foreign activities of the 8 U.S. SIFIs emanates from the U.K.[1] The magnitude of these financial relationships makes the U.S.–U.K. bilateral relationship by far the most important with regard to global financial stability. As a result, our two countries have a strong mutual interest in ensuring that, if such an institution should fail, it can be resolved at no cost to taxpayers and without placing the financial system at risk. An indication of the close working relationship between the FDIC and U.K. authorities is the joint paper on resolution strategies that we released in December.[2]

In addition to the close working relationship with the U.K., the FDIC and the European Commission (E.C.) have agreed to establish a joint Working Group comprised of senior staff to discuss resolution and deposit guarantee issues common to our respective jurisdictions. The Working Group will convene twice a year, once in Washington, once in Brussels, with less formal communications continuing in between. The first of these meetings will take place later this month. We expect that these meetings will enhance close coordination on resolution related matters between the FDIC and the E.C., as well as European Union Member States.

While there is clearly much more work to be done in coordinating SIFI resolution strategies across major jurisdictions, these developments mark significant progress in fulfilling the mandate of section 210 of the Dodd-Frank Act and achieving the type of international coordination that would be needed to effectively resolve a G–SIFI in some future crisis situation.

[1] Reported foreign activities encompass sum of assets, the notional value of off-balance-sheet derivatives, and other off-balance-sheet items of foreign subsidiaries and branches.

[2] "Resolving Globally Active, Systemically Important, Financial Institutions", *http://www.fdic.gov/about/srac/2012/gsifi.pdf.*

Stress Testing Final Rule

Section 165(i) of the Dodd Frank Act requires the FRB to conduct annual stress tests of Bank Holding Companies with assets of $50 billion or more and nonbank SIFIs designated by FSOC for FRB supervision. This section of the Act also requires financial institutions with assets greater than $10 billion, including insured depository institutions, to conduct company run stress tests in accordance with regulations developed by their primary Federal regulator. The FDIC views the stress tests as an important source of forward-looking analysis of institutions' risk exposures that will enhance the supervisory process for these institutions. We also have clarified that these requirements apply only to institutions with assets greater than $10 billion, and not to smaller institutions.

The FDIC issued a proposed rule to implement the requirements of section 165(i) in January 2012, and a final rule in October 2012. The rule, which is substantially similar to rules issued by the Office of the Comptroller of the Currency (OCC) and the FRB, tailors the timelines and requirements of the stress testing process to the size of the institutions, as requested by commenters on the proposed rule.

The agencies are closely coordinating their efforts in the promulgation of scenarios and the review of stress testing results. The first round of stress tests, for certain insured institutions and Bank Holding Companies with assets of $50 billion or more, is underway. Institutions were asked to develop financial projections under defined stress scenarios provided by the agencies in November 2012, based on their September 30, 2012, financial data. Institutions with assets greater than $10 billion, but less than $50 billion, and larger institutions that have not had previous experience with stress testing, will conduct their first round of stress tests this fall.

Other Dodd-Frank Act Rulemakings

The Volcker Rule

The Dodd-Frank Act requires the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC), and the Federal banking agencies to adopt regulations generally prohibiting proprietary trading and certain acquisitions of interest in hedge funds or private equity funds. The FDIC, jointly with the FRB, OCC, and SEC, published a notice of proposed rulemaking (NPR) requesting public comment on a proposed regulation implementing the prohibition against proprietary trading. The CFTC separately approved the issuance of its NPR to implement the Volcker Rule, with a substantially identical proposed rule text.

The proposed rule also requires banking entities with significant covered trading activities to furnish periodic reports with quantitative measurements designed to help differentiate permitted market-making-related activities from prohibited proprietary trading. Under the proposed rule, these requirements contain important exclusions for banking organizations with trading assets and liabilities less than $1 billion, and reduced reporting requirements for organizations with trading assets and liabilities of less than $5 billion. These thresholds are designed to reduce the burden on smaller, less complex banking entities, which generally engage in limited market-making and other trading activities.

The agencies are evaluating a large body of comments on whether the proposed rule represents a balanced and effective approach or whether alternative approaches exist that would provide greater benefits or implement the statutory requirements with fewer costs. The FDIC is committed to developing a final rule that meets the objectives of the statute while preserving the ability of banking entities to perform important underwriting and market-making functions, including the ability to effectively carry out these functions in less-liquid markets. Most community banks do not engage in trading activities that would be subject to the proposed rule.

Appraisal-Related Provisions

The final rule regarding appraisals for higher-risk mortgages, which implements section 1471 of the Dodd-Frank Act, was adopted by the FDIC and five other agencies earlier this year.[3] The final rule, which will become effective on January 18, 2014, requires creditors making higher-risk mortgages to use a licensed or certified appraiser who prepares a written appraisal report based on a physical visit of the interior of the property. The rule also requires creditors to disclose to applicants information about the purpose of the appraisal and provide consumers with a free copy of any appraisal report. Finally, if the seller acquired the property for a lower price during the prior 6 months and the price difference exceeds certain thresholds, creditors will have to obtain a second appraisal at no cost to the consumer. This

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[3] The other agencies are: the FRB, the Consumer Financial Protection Bureau, the Federal Housing Finance Agency, the National Credit Union Administration, and the OCC.

requirement is intended to address fraudulent property flipping by seeking to ensure that the value of the property legitimately increased. Certain types of loans are exempted from the rule, such as qualified mortgages, and there are limited exemptions from the second appraisal requirement. By ensuring that homes secured by higher-risk mortgages are appraised at their true market value by a qualified appraiser, the rule will benefit both lenders and consumers.

The agencies also are developing notices of proposed rulemaking to address other appraisal-related provisions of the Dodd-Frank Act. These provisions include registration and operating requirements for appraisal management companies and quality controls for automated valuation models. We look forward to considering the public comments we receive on these proposals.

Rulemaking on Risk Retention in Mortgage Securitization

Six agencies,[4] including the FDIC, previously issued a joint notice of proposed rulemaking seeking comment on a proposal to implement section 941 of the Dodd-Frank Act. The proposed rule would require sponsors of asset-backed securities to retain at least 5 percent of the credit risk of the assets underlying the securities and not permit sponsors to transfer or hedge that credit risk. The proposed rule would provide sponsors with various options for meeting the risk-retention requirements. It also provides, as required by section 941, proposed standards for a Qualified Residential Mortgage (QRM) which, if met, would result in exemption from the risk retention requirement.

The interagency staff group addressing the credit risk retention rule under section 941 of DFA has been working to address the numerous issues raised by the many comments received on the proposed rule. After initial discussions about QRM, in view of the fact that the statute provides that the definition of QRM can be no broader than the definition of QM, staff turned its attention to the non-QRM issues pending issuance by the Consumer Financial Protection Bureau (CFPB) of its QM rule. With the recent issuance of the QM rule by the CFPB, the interagency group plans to turn its attention back to issues regarding QRM.

Community Banking Initiatives

In light of concerns raised about the future of community banking in the aftermath of the financial crisis, as well as the potential impact of the various rulemakings under the Dodd-Frank Act, the FDIC engaged in a series of initiatives during 2012 focusing on the challenges and opportunities facing community banks in the United States.

FDIC Community Banking Study

In December 2012, the FDIC released the FDIC Community Banking Study, a comprehensive review of the U.S. community banking sector covering 27 years of data. The study set out to explore some of the important trends that have shaped the operating environment for community banks over this period, including: long-term industry consolidation; the geographic footprint of community banks; their comparative financial performance overall and by lending specialty group; efficiency and economies of scale; and access to capital. This research was based on a new definition of community bank that goes beyond size, and also accounts for the types of lending and deposit gathering activities and limited geographic scope that are characteristic of community banks.

Our research confirms the crucial role that community banks play in the American financial system. As defined by the Study, community banks represented 95 percent of all U.S. banking organizations in 2011. These institutions account for just 14 percent of the U.S. banking assets in our Nation, but hold 46 percent of all the small loans to businesses and farms made by FDIC-insured institutions. While their share of total deposits has declined over time, community banks still hold the majority of bank deposits in rural and micropolitan counties.[5] The Study showed that in 629 U.S. counties (or almost one-fifth of all U.S. counties), the only banking offices operated by FDIC-insured institutions at year-end 2011 were those operated by community banks. Without community banks, many rural areas, small towns, and even certain urban neighborhoods, would have little or no physical access to mainstream banking services.

Our Study took an in-depth look at the long-term trend of banking industry consolidation that has reduced the number of federally insured banks and thrifts from

[4] The rule was proposed by the FRB, the OCC, the FDIC, the SEC, the Federal Housing Finance Agency, and the Department of Housing and Urban Development.

[5] The 3,238 U.S. counties in 2010 included 694 micropolitan counties centered on an urban core with population between 10,000 and 50,000 people, and 1,376 rural counties with populations less than 10,000 people.

17,901 in 1984 to 7,357 in 2011. All of this net consolidation can be accounted for by an even larger decline in the number of institutions with assets less than $100 million. But a closer look casts significant doubt on the notion that future consolidation will continue at this same pace, or that the community banking model is in any way obsolete.

More than 2,500 institutions have failed since 1984, with the vast majority failing in the crisis periods of the 1980s and early 1990s and the period since 2007. To the extent that future crises can be avoided or mitigated, bank failures should contribute much less to future consolidation. In addition, about one third of the consolidation that has taken place since 1984 is the result of charter consolidation within bank holding companies, while just under half is the result of voluntary mergers. But both of these trends were greatly facilitated by the gradual relaxation of restrictions on intrastate branching at the State level in the 1980s and early 1990s, as well as the interstate branching that came about following enactment of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994. The pace of voluntary consolidation has indeed slowed over the past 15 years as the effects of these one-time changes were realized. Finally, the Study questions whether the rapid precrisis growth of some of the Nation's largest banks, which came about largely due to mergers and acquisitions and a focus on retail lending, can continue at the same pace going forward. Some of the precrisis cost savings realized by large banks have proven to be unsustainable in the postcrisis period, and a return to precrisis rates of growth in consumer and mortgage lending appears, for now anyway, to be a questionable assumption.

The Study finds that community banks that grew slowly and maintained diversified portfolios or otherwise stuck to their core lending competencies during the study period exhibited relatively strong and stable performance over time. Other institutions that pursued higher-growth strategies—frequently through commercial real estate or construction and development lending—encountered severe problems during real estate downturns and generally underperformed over the long run. Moreover, the Study finds that economies of scale play a limited role in the viability of community banks. While average costs are found to be higher for very small community banks, economies of scale are largely realized by the time an institution reaches $100 million in size, and there is no indication of any significant cost savings beyond $500 million in size. These results comport well with the experience of banking industry consolidation since 1984, in which the number of bank and thrift charters with assets less than $25 million has declined by 96 percent, while the number of charters with assets between $100 million and $10 billion has grown by 19 percent.

In summary, the FDIC Study finds that despite the challenges of the current operating environment, the community banking sector remains a viable and vital component of the overall U.S. financial system. It identifies a number of issues for future research, including the role of commercial real estate lending at community banks, their use of new technologies, and how additional information might be obtained on regulatory compliance costs.

Examination and Rulemaking Review

The FDIC also reviewed examination, rulemaking, and guidance processes during 2012 with a goal of identifying ways to make the supervisory process more efficient, consistent, and transparent—especially with regard to community banks—consistent with safe and sound banking practices. This review was informed by a series of nationwide roundtable discussions with community bankers, and with the FDIC's Advisory Committee on Community Banking.

Based on concerns raised, the FDIC has implemented a number of enhancements to our supervisory and rulemaking processes. First, the FDIC has revamped the preexam process to better scope examinations, define expectations and improve efficiency. Second, the FDIC is taking steps to improve communication by using Web-based tools to provide critical information regarding new or changing rules and regulations as well as comment deadlines. Finally, the FDIC has instituted a number of outreach and technical assistance efforts, including increased direct communication between examinations, increased opportunities for attendance at training workshops and symposiums, and current and planned conference calls and training videos on complex subjects of interest. The FDIC considers its review of examination and rulemaking processes ongoing, and additional enhancements and modifications to our processes will likely continue.

Conclusion

Successful implementation of the various provisions of the Dodd-Frank Act will provide a foundation for a financial system that is more stable and less susceptible to crises, and a regulatory system that is better able to respond to future crises. Significant progress has been made in implementing these reforms. The FDIC has completed the core rulemakings for carrying out its lead responsibilities under the Act regarding deposit insurance and systemic resolution. As we move forward in completing this process, we will continue to rely on constructive input from the regulatory comment process and our other outreach initiatives.

PREPARED STATEMENT OF THOMAS J. CURRY

COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

FEBRUARY 14, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to report on the Office of the Comptroller of the Currency's (OCC) progress in implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act or Act).* Before providing that progress report, however, I would like to begin with a brief review of current conditions in the portions of the banking industry that the OCC supervises.

The OCC supervises more than 1,800 national banks and Federal savings associations, constituting approximately 26 percent of all federally insured banks and savings associations which, together, hold more than 69 percent of all commercial bank and thrift assets. These institutions range in size from over 1,600 community banks with assets of $1 billion or less to the Nation's largest and most complex financial institutions with assets exceeding $1 trillion. I am pleased to report that the institutions we supervise have made significant strides since the financial crisis in repairing their balance sheets through stronger capital, improved liquidity, and timely recognition and resolution of problem loans. For national banks and Federal savings associations, Tier 1 common equity is at 12.5 percent of risk-weighted assets, up from its low of just over 9 percent in the fall of 2008.[1] The current capital leverage ratio is now about 9 percent, which is up almost a third from its recent low. Reliance on volatile funding sources has dropped from its fall 2006 peak of 46 percent of total liabilities to 24 percent today. Asset quality indicators are improving with charge-off rates declining for all major loan categories. Indeed, for all but residential mortgages, charge-off rates have now dropped below their post-1990 averages. Reflecting these positive trends, the number of problem institutions on the Federal Deposit Insurance Corporation's (FDIC) problem bank list has dropped from 888 in March 2011 to 694 in September 2012. Problem national banks and Federal savings associations dropped from 192 in March 2011 to 165 in September 2012. There were 146 problem national banks and Federal savings associations in January 2013.

While these are encouraging developments, banks and thrifts continue to face significant challenges. Net interest margins are being squeezed for both large and small banks. This problem is especially acute for banks under $1 billion in asset size—a group that represents 90 percent of the institutions we supervise—whose margins are near their 20-year low point. Loan growth, while improved, is still only about one-half its historical average pace. We are monitoring these conditions closely and are stressing that, in this environment, institutions should be especially vigilant about monitoring the risks they are taking on. This is certainly not the time to let up on risk management.

We are also mindful that we cannot let the progress that has been made lessen our sense of urgency in addressing the weaknesses and flaws the crisis revealed in our financial system. The global financial crisis was unprecedented in severity and duration, and the depth of the associated recession was the most severe we have experienced in the U.S. since the Great Depression of the 1930s. These financial and economic developments led to a reconsideration of the ways financial markets and financial firms operate and gave impetus to efforts to reform the financial system and its oversight. The Dodd-Frank Act addresses major gaps and flaws in the regulatory landscape, tackles systemic issues that contributed to, or accentuated and amplified, the effects of the recent financial crisis, and built a stronger financial system. The Act requires the Federal regulators to put in place new buffers and safeguards to protect against future financial crises and to revise and rewrite many of the rules governing the most complex areas of finance. Additionally, it consolidates authority that had been spread among multiple agencies, and it provides the Federal regulators a number of new tools that should help us avoid problems in the future.

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*Statement Required by 12 U.S.C. §250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

[1] Performance and financial data are based on September 30, 2012, Call Report information.

The OCC is committed to fully implementing those provisions where we have sole rule-writing authority as expeditiously as possible, and to working cooperatively with our regulatory colleagues on those rules and provisions that require coordinated or joint action. As I testified before this Committee in June, I am keenly aware of the critical role that community banks play in providing consumers and small businesses in communities across the Nation with essential financial services and access to credit. As we move forward with Dodd-Frank Act implementation, I have directed my staff to look for ways to minimize potential burden on community institutions, and to organize and explain our rulemaking documents to facilitate community bankers' understanding of how the rules affect their institutions.

In response to the Committee's letter of invitation, my testimony will focus on the OCC's overall implementation of the Dodd-Frank Act by providing an update on key provisions of the Act where the OCC has direct rulemaking or other implementation responsibilities.

OCC/OTS Integration

General

One of the most significant of the OCC's milestones in implementing the Dodd-Frank Act has been the successful integration of former Office of Thrift Supervision (OTS) employees and the supervision of Federal savings associations into the OCC. The commitment of all involved resulted in a smooth transition, reflecting a merger of experience with a strong vision for the future. This combination was helped by the close relationship forged over the years through our work on common problems and issues. In this spirit of continuity, the OCC has renewed the charters of two advisory committees that the OTS established. I recently attended the first meeting of the Mutual Savings Associations Advisory Committee, where participants engaged in a robust discussion about the challenges that mutual savings associations confront. At next month's Minority Depository Institutions Advisory Committee meeting, I look forward to a productive exchange about the issues that minority-owned depository institutions are facing.

Integration of Regulations

As we have reported previously to the Committee, the OCC also is engaged in a comprehensive effort to integrate the rules applicable to Federal savings associations with those that apply to national banks. Our objectives are, first, to develop a single rulebook applicable to both national banks and Federal savings associations (except where statutory differences between the two charter types require otherwise); and, second, for both charter types, to identify and eliminate regulatory requirements that are unnecessarily burdensome.

As I have noted before, while we believe a single set of rules will benefit both national banks and Federal savings associations, we recognize that change can create uncertainty. We are aiming to begin proposing these integrated rules over the course of this year. As part of our proposals, we will be seeking comments on ways that we can make our rules easier to implement and reduce burden, and I look forward to receiving comments from interested parties on this important issue.

Completed Rulemakings

Final Rule To Revise OCC Regulations To Remove References to Credit Ratings

On June 13, 2012, the OCC published in the *Federal Register* a final rule to implement section 939A of the Dodd-Frank Act by removing references to credit ratings from the OCC's noncapital regulations, including the OCC's investment securities regulation, which sets forth the types of investment securities that national banks and Federal savings associations may purchase, sell, deal in, underwrite, and hold.[2] These revisions became effective on January 1, 2013.

Under prior OCC rules, permissible investment securities generally included Treasury securities, agency securities, municipal bonds, and other securities rated "investment grade" by nationally recognized statistical rating organizations such as Moody's, S&P, or Fitch Ratings. The OCC's final rule revised the definition of "investment grade" to remove the reference to credit ratings and replaced it with a new nonratings based creditworthiness standard. To determine that a security is "investment grade" under the new standard, a bank must perform due diligence necessary to establish: (1) that the risk of default by the obligor is low; and (2) that full and timely repayment of principal and interest is expected. Generally, securities with good to very strong credit quality will meet this standard.

[2] The Federal banking agencies' June 2012 proposed capital rulemakings include provisions to remove references to credit ratings from the agencies' capital regulations.

In comments on the proposed rule, banks and industry groups expressed concern about the amount of due diligence the OCC will require a bank to conduct to determine whether the issuer of a security has an adequate capacity to meet financial commitments under the security. The OCC believes that the due diligence required to meet the new standard is consistent with our prior due diligence requirements and guidance. Under the prior ratings-based standards, national banks and Federal savings associations of all sizes should not have relied solely on credit ratings to evaluate the credit risk of a security, and were advised to supplement any use of credit ratings with additional diligence to independently assess the credit risk of a particular security. Nevertheless, the OCC recognized that some national banks and Federal savings associations needed time to make the adjustments necessary to make "investment grade" determinations under the new standard. Therefore, the OCC allowed institutions nearly 6 months to come into compliance with the final rule.

To aid this adjustment process, the OCC also published guidance to assist banks in interpreting the new standard and to clarify the steps banks can take to demonstrate that they meet their diligence requirements when purchasing investment securities and conducting ongoing reviews of their investment portfolios.

Final Rule on Dodd-Frank Stress Tests

On October 9, 2012, the OCC published a final rule that implements section 165(i)(2) of the Dodd-Frank Act and requires certain companies to conduct annual stress tests pursuant to regulations prescribed by their respective primary financial regulator. Specifically, this rule requires national banks and Federal savings associations with total consolidated assets over $10 billion (covered institutions) to conduct an annual stress test as prescribed by the rule.

Consistent with the requirements of section 165(i)(2), the final rule defines "stress test," establishes methods for the conduct of the company-run stress test that must include at least three different scenarios (baseline, adverse, and severely adverse), establishes the form and content of reporting, and compels the covered institutions to publish a summary of the results of the stress tests. Commenters on the proposal expressed concern that developing robust procedures for stress testing might require more time at some banks, particularly those that had not participated in the Supervisory Capital Assessment Program or Comprehensive Capital Analysis and Review program. Therefore, the final rule provided that covered institutions with assets over $50 billion were required to start stress testing under the rule in 2012, while covered institutions with assets from $10 to $50 billion are not required to start stress testing until 2013. The final rules of the Board of Governors of the Federal Reserve System (FRB) and the FDIC adopted similar transition provisions.

The requirements for these company-run stress tests are separate and distinct from the supervisory stress tests required under section 165(i)(1) that are conducted by the FRB. Nevertheless, we believe these efforts are complementary and as a result we are committed to working closely with the FRB and the FDIC in coordinating the timing of, and the scenarios for, these tests.

The company-run stress tests under this rule began with the release of stress scenarios by the OCC and other regulators on November 15, 2012, with scenarios covering baseline, adverse, and severely adverse conditions as required under the rule. The rule required covered institutions with more than $50 billion in assets to report the results of the stress tests to the OCC and the FRB by January 5, 2013. The OCC is in the process of reviewing those results. Covered institutions are required to disclose a summary of the results in March of this year.

Interim Final Rule on Lending Limits

The OCC also recently completed a rulemaking to implement Dodd-Frank Act changes to the lending limit rules. Under the National Bank Act, the total loans and extensions of credit by a national bank to a person outstanding at one time may not exceed 15 percent of the unimpaired capital and unimpaired surplus of the bank if the loan is not fully secured plus an additional 10 percent of unimpaired capital and unimpaired surplus if the loan is fully secured. The Home Owners' Loan Act applies this lending limits rule to savings associations, with some exceptions.

Section 610 of the Dodd-Frank Act amended the definition of "loans and extensions of credit" to include any credit exposure to a person arising from a derivative transaction, or a repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction (securities financing transaction) between a national bank and that person. This new definition also applies to savings associations. This amendment was effective July 21, 2012.

On June 21, 2012, the OCC issued an interim final rule and request for comments that amended the OCC's lending limits regulation to implement section 610 of the

Dodd-Frank Act and to provide guidance on how to measure the fluctuating credit exposure of derivatives and securities financing transactions for purposes of the lending limit. This interim rule also consolidated the OCC's lending limits rules applicable to national banks and savings associations. Specifically, the interim final rule provides national banks and savings associations with three methods for calculating the credit exposure of derivative transactions other than credit derivatives, and two methods for calculating such exposure for securities financing transactions. These methods vary in complexity and permit institutions to adopt compliance alternatives that fit their size and risk management requirements, consistent with safety and soundness and the goals of the statute. Providing these options is intended to reduce regulatory burden, particularly for smaller and midsize banks and savings associations. To permit institutions the time necessary to conform their operations to the amendments implementing section 610, the OCC has provided a temporary exception from the lending limit rules for extensions of credit arising from derivative transactions or securities financing transactions until July 1, 2013. The OCC expects to publish a final rule that amends and finalizes this interim rule in the near future.

Final Rule on Appraisals for Higher Priced Mortgage Loans

In the years leading up to the financial crisis, several consecutive periods of rapid increases in home prices put increasing pressure on the Nation's infrastructure for determining the value of properties in connection with underwriting mortgages. The Dodd-Frank Act reflects congressional concern about appraiser independence, appraisal management companies, and alternative property valuation techniques, and adopts several reform measures on these and related topics. Section 1471 of the Dodd-Frank Act, in particular, focuses on property valuation in connection with so-called "higher priced mortgage loans," (HPMLs) which are consumer mortgages made at interest rates that are typically indicative of subprime credit status of the borrower.

Section 1471 amended the Truth in Lending Act to require the OCC, along with the other Federal banking agencies, the Bureau of Consumer Financial Protection (CFPB), and the Federal Housing Finance Agency (FHFA), to issue regulations implementing three main requirements for HPML home valuations. First, a creditor is prohibited from extending an HPML to any consumer without first obtaining a full written appraisal performed by a certified or licensed appraiser who conducts a physical property visit of the interior of the property. Second, the creditor must obtain an additional written appraisal from a different certified or licensed appraiser if the HPML finances the purchase or acquisition of a "flipped" property—that is, a property being bought from a seller at a higher price than the seller paid, within 180 days of the seller's purchase or acquisition. The creditor may not charge the consumer for this additional appraisal. Third, the creditor must also provide the applicant with disclosures at the time of the initial mortgage application about the purpose of the appraisal, and must give the borrower a copy of each appraisal at least three days prior to the transaction closing date.

The agencies issued a joint final rule to implement section 1471 on January 18, 2013. Creditors have 1 year to come into compliance with the new rule's requirements. Consistent with the statute, the final rule exempts all HPMLs that meet the CFPB's definition of a "qualified mortgage" (QM) under the CFPB's "ability to repay" mortgage rules. The CFPB has indicated that this QM exemption will cover a significant portion of the current mortgage market. The agencies also incorporated exemptions from the second appraisal requirement for a number of different types of transactions, including sales in rural areas, and sales by servicemembers who receive deployment or change of station orders.

The agencies also included two key provisions in the final rule to provide creditors with clear guidance on their obligations under the statute. First, the rule provides a specific set of standards the creditor can apply in determining whether the appraiser has submitted an appraisal report that meets the requirements of the statute for an appraisal prepared in accordance with the Uniform Standards of Appraisal Practice and the banking agencies' appraisal regulations pursuant to Title XI of the Financial Institutions Recovery, Reform, and Enforcement Act of 1989. Creditors applying these standards in connection with their review of each appraisal are afforded a safe harbor under the rule. Second, for HPMLs that are originated to fund the purchase of a dwelling, the rule provides numerous examples of the types of documents a creditor may rely upon in determining whether the seller is "flipping" the property within the meaning of the statute.

Final Rule on Retail Foreign Exchange Transactions

On July 14, 2011, the OCC published in the *Federal Register* its final retail foreign exchange transactions rule (Retail Forex Rule) for national banks and Federal branches and agencies of foreign banks. The Retail Forex Rule imposes a variety of consumer protections—including margin requirements, required disclosures, and business conduct standards—on foreign exchange options, futures, and futures-like transactions with retail customers (persons that are not eligible contract participants under the Commodity Exchange Act). To promote regulatory comparability, the OCC worked closely with the Commodity Futures Trading Commission (CFTC), Securities Exchange Commission (SEC), FDIC, and FRB in developing the OCC Retail Forex Rule and modeled the OCC Retail Forex Rule on the CFTC's rule.

After the transfer of regulatory authority from the OTS, the OCC updated its Retail Forex Rule to apply to Federal savings associations. This interim final rule with request for comments was published in the *Federal Register* on September 12, 2011. The OCC also proposed last October to update its Retail Forex Rule to incorporate the CFTC's and SEC's recent further definition of "eligible contract participant" and related guidance. The OCC is currently working to finalize that proposal.

Ongoing Dodd-Frank Act Rulemakings

The OCC also is continuing to work closely with other Federal financial agencies on a number of important regulations to implement provisions of the Dodd-Frank Act where we have joint rulemaking responsibility. I am committed to completing these rulemakings as quickly as possible while recognizing the need to carefully consider and address the important issues that commenters have raised with the proposals.

Volcker Rule

Section 619 of the Dodd-Frank Act added a new section 13 to the Bank Holding Company Act that contains certain prohibitions and limitations on the ability of a banking entity and a nonbank financial company supervised by the FRB to engage in proprietary trading and to have certain interests in, or relationships with, a hedge fund or private equity fund. The OCC, FDIC, FRB, and the SEC issued proposed rules implementing that section's requirements on October 11, 2011. On January 3, 2012, the period for filing public comments on this proposal was extended for an additional 30 days, until February 13, 2012. On January 11, 2012, the CFTC issued a substantively similar proposed rule implementing section 619 and invited public comment through April 16, 2012. The agencies received more than 18,000 comments regarding the proposed implementing rules and are carefully considering these comments as they work toward development of final rules.

Commenters, including members of Congress, representatives of Federal and State agencies, foreign Governments, domestic and foreign banking entities and industry trade associations, public interest groups, academics and private citizens, offered a wide range of perspectives on nearly every aspect of the proposed rule. Overall, commenters urged the agencies to simplify the final rule, to reduce compliance burdens for entities that do not engage in significant trading or covered fund activities, and to address unintended consequences of the proposed rule. Some commenters urged the agencies to adopt a final rule that would set forth fairly prescriptive standards and narrowly construed exemptions as they believed this would minimize potential loopholes and the possibility of evasion. Other commenters urged the agencies to adopt a more flexible, principles-based approach in the final rule as they believed this would reduce burden and lessen possible unintended consequences.

For example, an area that has drawn much attention from commenters is the proposed approach for distinguishing permissible market-making-related activities from prohibited proprietary trading. Commenters expressed concern that the proposed rule could have an adverse impact on financial markets, investors, and customers that rely on such markets for liquidity. Other commenters advocated that the market-making exemption should be narrowed. Commenters also highlighted issues with the proposed approach for implementing the prohibition on investing in and having certain relationships with a hedge fund and private equity funds, in particular with the manner in which the proposal defines what is a covered fund. Some commenters thought the proposed definition of covered fund was over-inclusive, while others felt it was under-inclusive. Finally, commenters addressed the international implications of the proposal, both in terms of competitiveness of U.S. banking entities and the extraterritorial impact of the proposal on activities of non-U.S. banking entities conducted solely outside of the United States.

Section 619, by its terms, became effective on July 21, 2012. The FRB, in consultation with the other agencies, issued rules governing the period for conforming with Section 619 and in a statement issued on April 19, 2012, further clarified that covered entities have a period of 2 years after the statutory effective date, which would be until July 21, 2014, to fully conform their activities to the statutory provisions and any final rules adopted, unless the period is extended by the FRB. The OCC, FDIC, SEC, and the CFTC confirmed that they plan to administer their oversight of banking entities under their respective jurisdiction in accordance with the FRB's statement of April 19.

The OCC, together with the other agencies, continues to work diligently in reviewing the comments submitted during the rulemaking process and toward the development of final rules consistent with the statutory language. To ensure, to the extent possible, that the rules implementing section 619 are comparable and provide for consistent application, the OCC has been regularly consulting with the other agencies and will continue to do so.

Credit Risk Retention Rulemaking

Securitization markets are an important source of credit to U.S. households, businesses, and State and local governments. When properly structured, securitization provides economic benefits that lower the cost of credit. However, when incentives are not properly aligned and there is a lack of discipline in the origination process, securitization can result in harm to investors, consumers, financial institutions, and the financial system. During the financial crisis, securitization displayed significant vulnerabilities, including informational asymmetries and incentive problems among various parties involved in the process. To address these concerns, section 941 of the Dodd-Frank Act requires the OCC, together with the other Federal banking agencies, as well as the Department of Housing and Urban Development, FHFA, and the SEC, to require sponsors of asset-backed securities to retain at least 5 percent of the credit risk of the assets they securitize. The purpose of this new regulatory regime is to correct adverse market incentive structures by giving securitizers direct financial disincentives against packaging loans that are underwritten poorly.

Pursuant to this requirement, the agencies issued a joint proposed rulemaking in the *Federal Register* on April 29, 2011. The proposal includes a number of options by which securitization sponsors could satisfy the statute's central requirement to retain at least 5 percent of the credit risk of securitized assets. This aspect of the proposal is designed to recognize that the securitization markets have evolved over time to foster liquidity in a wide diversity of different credit products, using different types of securitization structures and to avoid a "one size fits all" approach that would disrupt private securitization and restrict credit availability.

The proposal would also establish certain exemptions from the risk retention requirement, most notably, an exemption for securitizations backed entirely by "qualified residential mortgages" (QRMs). Consistent with the statutory provision, the definition of QRM includes underwriting and product features that historical loan performance data indicate result in a low risk of default. The proposed QRM definition seeks to set out a conservative, verifiable set of underwriting standards that would provide clarity and confidence to mortgage originators, securitizers, and investors about the loans that would qualify for the exemption. The standards are also designed to simultaneously foster securitization of non-QRM loans, by leaving room for a liquid and competitive market of soundly underwritten non-QRM loans sufficient to support robust securitization activity.

The proposal generated significant levels of comment on a number of key issues from loan originators, securitizers, consumers, and policy makers. These comments included the role of risk retention and the QRM exemption in the future of the residential mortgage market. Most commenters on the QRM criteria expressed great concern that the QRM criteria were too stringent, particularly the 80 percent loan-to-value requirement for purchase money mortgages. Several commenters also were divided on the current risk retention practices of Fannie Mae and Freddie Mac, with some opposing the difference in treatment from private securitizers and others favoring it in recognition of the market liquidity the GSEs presently provide. We recognize this is a significant policy area and are continuing to review the issue.

The proposed menu of risk retention alternatives also attracted significant comment. While many commenters supported the overall approach, securitizers raised numerous concerns about whether the particular options would accommodate established structures for risk retention in differing types of securitization transactions. These commenters recommended a number of structural modifications to the details of the risk retention alternatives.

The agencies have carefully evaluated this extensive body of comments. In addition, the agencies have reviewed the QM criteria issued by the CFPB in January, to which the QRM criteria are statutorily linked. With the QM criteria completing the picture, the agencies are now in a position to consolidate the analytical work done since the comment period closed and finalize the rule.

Margin and Capital Requirements for Covered Swap Entities

During the financial crisis, the lack of transparency in derivatives transactions among dealer banks and between dealer banks and their counterparties created uncertainty about whether market participants were significantly exposed to the risk of a default by a swap counterparty. To address this uncertainty, sections 731 and 764 of the Dodd-Frank Act require the OCC, together with the FRB, FDIC, FHFA, and Farm Credit Administration, to impose minimum margin requirements on noncleared derivatives.

The OCC, together with the FRB, FDIC, FHFA, and Farm Credit Administration, published a proposal in the *Federal Register* on May 11, 2011, to establish minimum margin and capital requirements for registered swap dealers, major swap participants, security-based swap dealers, and major security-based swap participants (swap entities) subject to agency supervision. To address systemic risk concerns, consistent with the Dodd-Frank Act requirement, the agencies proposed to require swaps entities to collect margin for all uncleared transactions with other swaps entities, and with financial counterparties. However, for low-risk financial counterparties, the agencies proposed that swap entities would not be required to collect margin as long as its margin exposure to a particular low-risk financial counterparty does not exceed a specific threshold amount of margin. Consistent with the minimal risk that derivatives with commercial end users pose to the safety and soundness of swap entities and the U.S. financial system, the proposal also included a margin threshold approach for these end users, with the swap entity setting a margin threshold for each commercial end user in light of the swap entity's assessment of credit risk of the end user. The proposed margin requirements would apply to new, noncleared swaps or security-based swaps entered into after the proposed rule's effective date.

With very limited exception, commenters opposed the agencies' proposed treatment of commercial end users. They urged the agencies to implement a categorical exemption, like the statutory exception from clearing requirements for commercial end users. They also indicated that the agencies' proposal on documentation of margin obligations was a departure from existing practice and burdensome to implement. They further indicated that, as drafted, the agencies' proposed threshold-based approach was inconsistent with the current credit assessment-based practices of swaps entities. Commenters also raised a number of other important issues, including the types of collateral eligible to be posted for margin obligations, and concerns that the agencies' proposed margin calculation methodology was not properly calibrated to the level of risk presented by the underlying transactions. They also expressed concerns that U.S. and foreign regulators must coordinate as to the level and effective dates of their respective margin requirements, and anticipated that unilateral U.S. implementation of margin rules would eliminate U.S. banks' ability to continue competing in foreign markets that are behind the U.S. in formulating margin rules for their own dealers.

Given the global nature of major derivatives markets and activities, we agree that international harmonization of margin requirements is critical, and we are participating in efforts by the Basel Committee on Bank Supervision (BCBS) and International Organization of Securities Commissions (IOSCO), to address coordinated implementation of margin requirements across G20 Nations. The BCBS–IOSCO working group issued a consultative document in July of 2012, seeking public feedback on a broad policy framework for margin requirements on uncleared swap transactions that would be applied on a coordinated and nonduplicative basis across international regulatory jurisdictions. We and the other U.S. banking agencies and the CFTC re-opened the comment periods on our margin proposals to give interested persons additional time to analyze those proposals in light of the BCBS–IOSCO consultative framework. The banking agencies' comment period closed on November 26, 2012. Most commenters once again focused on the treatment of commercial end users, urging the agencies to adopt the exemptive approach suggested by the BCBS–IOSCO proposal. The BCBS–IOSCO working group continues its discussions with its parent committees to analyze the questions and alternatives presented in the working group's consultative document, and to formulate a regulatory template to guide the participating jurisdictions to a coordinated regulatory structure on uncleared swap margin issues.

Also notable with regard to swap entities, section 716 of the Dodd-Frank Act prohibits the provision of Federal assistance (i.e., use of certain FRB advances and FDIC insurance or guarantees for certain purposes) to swaps entities with respect to any swap, security-based swap or other activity of the swaps entity. On May 10, 2012, the OCC, FRB, and FDIC published joint guidance for those entities for which they are each the prudential regulator to clarify that the effective date of section 716, i.e., the date on which the prohibition would take effect, is July 16, 2013.

Under section 716, following consultation with the CFTC or the SEC, the Federal banking agencies shall permit insured depository institutions that qualify as swap entities subject to the prohibition on Federal assistance, a transition period of up to 24 months to either divest the swaps entity or cease the activities that would require registration as a swaps entity. The transition period may be extended for up to one additional year by the Federal banking agencies after consultation with the CFTC or SEC. The OCC has received a number of requests from national banks for transition periods under section 716 and we are in the process of reviewing and evaluating these requests pursuant to the statutory requirements.

Incentive-Based Compensation

Pursuant to section 956 of the Dodd-Frank Act, in April 2011, the OCC, FRB, FDIC, OTS, National Credit Union Association (NCUA), SEC, and the FHFA (the agencies) issued a joint proposed rule that would require the reporting of certain incentive-based compensation arrangements by a covered financial institution and prohibit incentive-based compensation arrangements at a covered financial institution that provide excessive compensation or that could expose the institution to inappropriate risks that could lead to a material financial loss. [3]

The material financial loss provisions of the proposed rule would establish general requirements applicable to all covered institutions and additional proposed requirements applicable to certain larger covered financial institutions. The generally applicable requirements would provide that an incentive-based compensation arrangement, or any feature of any such arrangement, established or maintained by any covered financial institution for one or more covered persons, must balance risk and financial rewards and be compatible with effective controls and risk management, and supported by strong corporate governance.

The proposed rule included two additional requirements for "larger financial institutions," which for the Federal banking agencies, NCUA and the SEC means those covered financial institutions with total consolidated assets of $50 billion or more. First, a larger financial institution would be required to defer 50 percent of incentive-based compensation for its executive officers for a period of at least 3 years. Second, the board of directors (or a committee thereof) of a larger financial institution also would be required to identify, and approve the incentive-based compensation arrangements for, individuals (other than executive officers) who have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance. These individuals may include, for example, traders with large position limits relative to the institution's overall risk tolerance and other individuals that have the authority to place at risk a substantial part of the capital of the covered financial institution.

The agencies received thousands of comments on the proposal, many of which concerned the additional requirements for larger financial institutions. The agencies are continuing to work together to prepare a final rule that will address the many issues raised by the commenters.

Conclusion

I appreciate the opportunity to update the Committee on the work the OCC has done to implement the provisions of the Dodd-Frank Act, in particular, the completion of a number of important rulemakings and the significant progress that has been made on ongoing regulatory projects. While much has been accomplished, we will continue to move these ongoing projects toward completion. We look forward to keeping the Committee apprised of our progress.

PREPARED STATEMENT OF RICHARD CORDRAY

DIRECTOR, CONSUMER FINANCIAL PROTECTION BUREAU

FEBRUARY 14, 2013

Introduction

Thank you Chairman Johnson, Ranking Member Crapo, and Members of the Committee for inviting me back today to testify about implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. My colleagues and I at the Consumer Financial Protection Bureau are always happy to testify before the Congress, something we have done now 30 times.

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[3] A "covered financial institution" is a depository institution or depository institution holding company; a registered broker-dealer; a credit union; an investment adviser; Fannie Mae; Freddie Mac; and "any other financial institution" that the regulators jointly determine, by rule, should be covered by section 956.

Congress created the Bureau in the wake of the greatest financial crisis since the Great Depression. Our mission is to make consumer financial markets work for both consumers and responsible businesses.

Since the Bureau opened for business in 2011, our team has been hard at work. We are examining both banks and nonbank financial institutions for compliance with the law and we have addressed and resolved many issues through these efforts. In addition, for consumers who have been mistreated by credit card companies, we have worked in coordination with our fellow regulators to return roughly $425 million to their pockets. For those consumers who need information or help in understanding financial products and services, we have developed AskCFPB, a database of hundreds of answers to questions frequently asked by consumers. And our Consumer Response center has helped more than 100,000 consumers with their individual problems related to their credit cards, mortgages, student loans, and bank accounts.

We have also faithfully carried out the law that Congress enacted by writing rules designed to help consumers throughout their mortgage experience—from signing up for a loan to paying it off. In the Dodd-Frank Act, Congress gave the Bureau the responsibility to adopt specific mortgage rules with a legal deadline of January 21, 2013. If we had failed to do so, there were specific statutory provisions that would have automatically taken effect, which would have been problematic in various respects for consumers and the financial industry alike. We worked hard to meet our deadlines on those rules, which are the focus of my testimony today.

Ability-to-Repay

As we all know now, one of the reasons for the collapse of the housing market in 2007 and 2008 was the dramatic decline in underwriting standards in the mortgage market in the years leading up to the crisis. It became a race to the bottom, and in the end it was the American public and the American economy who were the losers in that unappetizing race. Many mortgage lenders made loans that borrowers had little realistic chance of being able to pay back. Some of those loans were high priced; many contained risky features. For example, lenders were selling "no-doc" (no documentation) and "low-doc" (little documentation) mortgages to consumers who were "qualifying" for loans beyond their means. Far too many borrowers found they had no problem getting so-called "NINJA" loans—even if you had no income, no job, and no assets, you still could get a loan.

The Dodd-Frank Act contains a provision to protect consumers from irresponsible mortgage lending by requiring lenders to make a reasonable, good faith determination based upon verified and documented information that prospective borrowers have the ability to repay their mortgages. Last month, the Bureau issued a rule to implement that requirement and provide further clarity as to what will be required of lenders.

In writing the Ability-to-Repay rule, we recognized that today's consumers are faced with a very different problem than the one that consumers faced before the crisis. Access to credit has become so constrained that many consumers—even those with strong credit—cannot refinance or buy a house.

So our rule strikes a balance and addresses both problems by enabling safer lending and providing certainty to the market. It rests on two basic, commonsense precepts: Lenders will have to check on the numbers and make sure the numbers check out. It is the essence of responsible lending.

Under the rule, lenders will have to evaluate the borrower's income, savings, other assets, and debts. No-doc loans are prohibited, and affordability cannot be evaluated based only on low introductory "teaser" interest rates. By rooting out reckless and unsustainable lending, while enabling safer lending, the rule protects consumers and strengthens the housing market.

In addition, Congress created a category of "Qualified Mortgages" that are presumed to meet the ability-to-repay requirements because they are subject to additional safeguards. Congress defined some of the criteria for these Qualified Mortgages, but recognized that it may be necessary for the Bureau to prescribe further specifics.

Our rule prohibits certain features that often have harmed consumers. Qualified mortgages cannot be negative-amortization loans—where the principal amount actually increases for some period because the borrower does not even pay the interest, and the unpaid interest gets added to the amount borrowed—or have interest-only periods. They cannot have up-front costs in points and fees above the level specified by Congress.

The rules also require that lenders carefully assess the burden that the loan places on the borrower. The consumer's total monthly debts—including the mortgage payment and related housing expenses such as taxes and insurance—generally cannot add up to more than 43 percent of a consumer's monthly gross income. The Bureau believes that this standard will help to draw a clear line that will provide a real measure of protection to borrowers and increased certainty to the mortgage market.

Loan Origination

The second rule I want to tell you about today has to do with mortgage loan originators.

Mortgage loan originators, which include mortgage brokers and retail loan officers, perform a variety of valuable services. They can assist consumers in obtaining or applying for mortgage loans, and they can offer or negotiate terms of those loans, whether the loans are for buying a home or refinancing an existing one. The financial reform law placed certain restrictions on a mortgage loan originator's qualifications and compensation. Building on rules issued earlier by the Federal Reserve, the Bureau applied what it heard from industry and consumers across the country to implement the new statutory restrictions.

The rules address critical conflicts of interest created by certain compensation practices in the run-up to the financial crisis, such as paying loan originators more money whenever they steered consumers into a more expensive loan and allowing them to take payments from both consumers and creditors in the same transaction. These practices gave loan originators strong incentives to steer borrowers toward risky and high-cost loans, and they created confusion among consumers about loan originators' loyalties. Restricting these practices will help ensure the mortgage market is more stable and sustainable.

Specifically, our mortgage loan origination rules help ensure that loan originator compensation may not be based on the terms of the mortgage transaction. At the same time, the rules spell out legitimate and permissible compensation practices, such as allowing certain profit-sharing plans. The rules say a broker or loan officer cannot get paid more by directing the consumer toward a loan with a higher interest rate, a prepayment penalty, or higher fees. The loan originator cannot get paid more for directing the consumer to buy an additional product like title insurance from the lender's affiliate. The rules also ban "dual compensation," whereby a broker gets paid by both the consumer and the creditor for the same transaction. Finally, our rules make existing requirements more consistent on matters such as screening, background checks, and training of loan originators, to provide more confidence to consumers.

Mortgage Servicing

For consumers who already have mortgage loans and are paying them back, the Bureau has adopted mortgage servicing rules to give them greater protections. The rules require commonsense policies and procedures for servicers' handling of consumer accounts.

By bearing responsibility for managing mortgage loans, mortgage servicers play a central role in homeowners' lives. They collect and apply payments to loans. They can work out modifications to loan terms. And they handle the difficult foreclosure process.

Even before the mortgage crisis unfolded, many servicers failed to provide a basic level of customer service. As the crisis unfolded, problems worsened. Servicers were unprepared to work with the number of borrowers who needed help. People did not get the help or support they needed, such as timely and accurate information about their options for saving their homes. Servicers failed to answer phone calls, lost paperwork, and mishandled accounts. Communication and coordination were poor, leading many homeowners to think they were on their way to a solution, only to find later that their homes had been foreclosed on and sold. In some cases, people arrived home to find they had been locked out unexpectedly.

To compound the frustrations, often the consumer's relationship with a mortgage servicer is not a matter of choice. After a borrower picks a lender and takes on a mortgage, the responsibility for managing that loan can be transferred to another provider without any approval from the borrower. So if consumers are dissatisfied with their customer service, they cannot protect themselves by switching to another servicer.

In this market, as in every other, consumers have the right to expect information that is clear, timely, and accurate. The Dodd-Frank Act added protections to consumers by establishing new servicer requirements. Last month, the Bureau issued rules to implement these provisions.

These provisions require that payments must be credited the day they are received. They require servicers to deal promptly with consumer complaints about errors. They require servicers to provide periodic statements to mortgage borrowers that break downpayments by principal, interest, fees, and escrow. They require disclosure of the amount and due date of the next payment. (To help industry on this requirement, the Bureau is providing model forms that we developed and tested with consumers.)

Our servicing rules also implement Dodd-Frank Act requirements that mortgage servicers provide earlier advance notice the first time an interest rates adjusts for most adjustable-rate mortgages. The disclosure must provide an estimate of the new interest rate, the payment amount, and when that payment is due. It must also include information about alternatives and counseling services, which can provide valuable assistance for consumers in all circumstances, and particularly if the new payment turns out to be unaffordable.

All of these Dodd-Frank provisions address normal mortgage servicing. They protect everyday mortgage borrowers from costly surprises and runarounds by their servicers. But the Dodd-Frank Act did not speak specifically or comprehensively to the unique problems faced by borrowers who fall behind on their mortgages. Instead, Congress gave the Bureau general rulemaking authority to address these kinds of consumer protection problems.

Many American homeowners are struggling to stay on top of their mortgages. Our Office of Consumer Response has already fielded more than 47,000 complaints about mortgages. More than half were about problems people have when they are unable to make their payments, such as issues relating to loan modifications, collections, or foreclosure.

Accordingly, the Bureau's mortgage servicing rules put into place fairer and more effective processes for troubled borrowers. Beginning with the early stage of delinquency, we are providing new protections to help consumers save their homes.

Under our rules, servicers will be required to establish policies and procedures to ensure that their records are accurate and accessible. The idea is that servicers should be able to provide correct and timely information to borrowers, mortgage owners (including investors), and the courts. This provision will help prevent the egregious "robo-signing" practices that were found to be rampant in the marketplace. The rules also require servicers to have policies and procedures that assure a smooth transfer of information—including pending applications for foreclosure alternatives—when an account transfers from one servicer to another.

Our rules also require that servicers reach out to borrowers within the first 36 days after a payment is delinquent to determine whether the borrowers may need assistance. After 45 days, servicers must provide information about loss mitigation options and make staff available who will be responsible for helping borrowers apply for loan modifications or other foreclosure alternatives. The rules also carefully regulate the process for evaluating borrowers' loss mitigation applications and so-called "dual tracking," where a consumer is being evaluated for loss mitigation at the same time that the servicer is taking steps to foreclose on the property. The rules are designed to ensure that borrowers who submit a complete application by specified timelines are assessed for all available loss mitigation options and have an opportunity to appeal mistakes to their servicer.

The rules also require servicers to maintain policies and procedures that will ensure better coordination with loan owners to ensure that servicers offer all loss mitigation options that the owners permit, correctly apply the criteria for the loss mitigation options, and report back to the loan owners about how borrower applications are resolved. The goal is to avoid needless foreclosures—which is in the best interest of the borrower, the lender, and our entire economy.

In pursuing these rules, the Bureau struck a carefully calibrated balance. The rules mandate a fair process but do not require that a servicer, or an investor, offer any particular type of loss mitigation option or apply any particular criteria in considering such options. The rules likewise balance private and public enforcement.

Importantly, the rules apply to the entire market, not just to banks and other depository institutions. Many provisions are subject to private enforcement directly by consumers, and others will be monitored closely by the Bureau and other regulators. The rules also ensure better communications with loan owners, including investors, so that they too can be more effective in monitoring servicers' activities.

We will be vigilant about monitoring and enforcing these rules, and are coordinating on an ongoing basis with other Federal agencies to address servicing issues. These rules mean a brand-new day for effective oversight of mortgage servicers by ensuring that no servicer can act in a manner that is indifferent to the plight of consumers.

Other Rules

The Bureau has also issued rules to implement a number of other provisions in the Dodd-Frank Act to strengthen consumer protections and address problematic practices that existed in the run-up to the financial crisis. For instance, the rules implement strict limitations on prepayment penalties that may have discouraged or disabled consumers from refinancing expensive or risky loans. The rules require creditors to maintain escrow accounts for borrowers who take out higher-priced mortgage loans for a longer period to help borrowers set aside money for taxes and property insurance. We also adopted new rules implementing the statutory requirement that mortgage lenders automatically provide applicants with free copies of all appraisals and other home-value estimates, as well as new and broader protections for high-cost "HOEPA" loans.

And in partnership with the Federal Reserve, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, National Credit Union Administration, and Office of the Comptroller of the Currency, the Consumer Bureau adopted a new rule that implements Dodd-Frank's special requirements for appraisals of certain higher-priced mortgage loans. By requiring that creditors use a licensed or certified appraiser to prepare the written appraisal report based on a physical inspection of the property, the new rule creates an additional level of due diligence. The rule also requires creditors to disclose to applicants information about the purpose of the appraisal and provide consumers with a free copy of any appraisal report.

Smaller Institutions

As the Bureau worked through the requirements Congress imposed in the Dodd-Frank Act, we paid attention to the potential impacts on different types and sizes of creditors, servicers, and other financial service providers. To inform its work, the Bureau received input from banks, other lenders, mortgage brokers, service providers, trade associations, consumer groups, nonprofits, and other Government stakeholders. We also convened small business review panels for input on various rules as prescribed by statute.

It is widely accepted that with few exceptions, community banks and credit unions did not engage in the kind of misdeeds that led to the mortgage crisis. Data available to the Bureau indicates that these institutions have lower severe delinquency rates and loss rates. At the same time, the Bureau knows these institutions may be more likely to retreat from the mortgage market if the regulations implementing the Dodd-Frank Act are too burdensome.

Accordingly, the Bureau created specific exceptions and tailored various rules to encourage small providers such as community banks and credit unions to continue providing credit and other services, while carefully balancing consumer protections. For example, we expanded earlier proposals to exempt certain small creditors operating predominantly in rural or underserved areas from the escrow rule requirements. We also issued a further proposal along with the Ability-to-Repay rule, which would treat various loans held by small creditors in portfolio as "Qualified Mortgages" subject to protections against any potential liability. We also finalized exceptions to substantial portions of our servicing rules for small companies such as community banks and credit unions that are servicing loans they originated or own.

We have carefully calibrated concerns about consumer protection and access to credit in making these distinctions. We know community banks and credit unions have strong practical reasons to provide responsible credit and have a long tradition of excellent customer service, both to protect their own balance sheets and because they care deeply about their reputations in their local communities. We know they provide vital financial services in rural areas, small towns, and underserved communities across this country. We believe the rules strike an appropriate balance to ensure consumers can continue to access this source of valuable and responsible credit.

Conclusion

As the Bureau has been working to finalize these mortgage rules by the statutory deadline, we have also been thinking hard about the process for implementing them. We know the new protections afforded by the Dodd-Frank Act and our rules will no doubt bring great change to the mortgage market, and we are committed to doing what we can to achieve effective, efficient, complete implementation by engaging with all stakeholders in the coming year. We know that it is in the best interests of the consumer for the industry to understand these rules—because if they cannot understand, they cannot properly implement.

To this end, we have announced an implementation support plan. We will publish plain-English summaries. We will publish readiness guides to help industry run through check-lists of things to do prior to the rules going into effect—like updating their policies and procedures and providing training for staff. We will work with other Government agencies to prepare in a transparent manner for both our and their examinations. And we will publish clarifications of the rules as needed to respond to questions and inquiries.

Most importantly, we will continue to listen to consumers and businesses as we work to help the mortgage market—and American consumers—recover from the financial crisis.

I am very proud of the tremendous work our team has done on rulemaking and implementation efforts under the Dodd-Frank Act. And as I have said to you before, we always welcome your questions and your thoughts about our work.

Thank you.

PREPARED STATEMENT OF ELISSE B. WALTER

CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

FEBRUARY 14, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee: Thank you for inviting me to testify on behalf of the Securities and Exchange Commission regarding our ongoing implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "Act"). We appreciate the opportunity to share with you the steps we have been taking and the procedures we have followed.

As you know, the Dodd-Frank Act added significant new responsibilities to the SEC's portfolio, as well as creating new tools for use in executing those and other responsibilities. To date, the Commission has made substantial progress in writing the huge volume of new rules the Act directs, as well as in conducting the various studies required by the Act. Of the more than 90 Dodd-Frank provisions that require SEC rulemaking, the SEC has proposed or adopted rules for over 80 percent of them, and also has finalized 17 of the more than 20 studies and reports that the Act directs us to complete. While this has been a challenge, the considerable progress the Commission has made is a direct result of the thoughtful, thorough, and professional efforts of our staff, whose efforts in fulfilling the Dodd-Frank Act mandates have come in addition to carrying their normal workloads.

My testimony today will provide an overview of the Commission's Dodd-Frank Act activities, emphasizing our accomplishments over the past year.

Hedge Fund and Other Private Fund Adviser Registration and Reporting

The Dodd-Frank Act mandated that the Commission require private fund advisers (including hedge and private equity fund advisers) to confidentially report information about the private funds they manage for the protection of investors or for the assessment of systemic risk by the Financial Stability Oversight Council (FSOC). On October 31, 2011, in a joint release with the Commodity Futures Trading Commission (CFTC), the Commission adopted a new rule that requires hedge fund advisers and other private fund advisers registered with the Commission periodically to report systemic risk information on a new form, "Form PF". [1]

Under the rule, registered investment advisers managing at least $150 million in private fund assets must periodically file Form PF. Both the amount of information required to be reported and the frequency with which Form PF must be filed are scaled to the size of the adviser and the nature of its advisory activities. [2] This scaled approach will provide FSOC and the Commission with a broad view of the industry while relieving smaller advisers from much of the reporting burden. In addition, the reporting requirements are tailored to the types of funds an adviser manages and the potential risks those funds may present, meaning that an adviser will respond only to questions relevant to its business model. The Dodd-Frank Act provides special confidentiality protections for this data. To ensure that the data is handled in a manner that reflects its sensitivity and statutory confidentiality protections, a Steering Committee composed of senior officers from various Divisions and Offices within the Commission has been established to implement a consistent approach regarding the access to, and use, sharing, and data security of, information collected through Form PF. The Steering Committee is also working with FINRA (the contractor that operates the Form PF filing system) and the Office of Financial

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[1] *See,* Release No. IA-3308, "Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF" (October 31, 2011), *http://www.sec.gov/rules/final/2011/ia-3308.pdf.*

[2] To the extent an investment adviser is currently required to file Form PF, examination staff review the individual filings prior to conducting investment adviser examinations. The review of Form PF assists in identifying additional risk areas and may highlight particular funds for focus during the exam.

Research (the FSOC entity that will receive and use the data on behalf of FSOC) to implement appropriate controls to protect it.

The largest advisers to liquidity funds and hedge funds began filing Form PF reports in the summer of 2012. As of December 31, 2012, the Commission received filings from 228 registered advisers of private funds. Smaller private fund advisers generally must begin filing with the Commission in March and April of this year.

In addition to Form PF, the Commission has implemented a number of other Dodd-Frank provisions that serve to enhance oversight of private funds advisers. These enable, for the first time, regulators and investors to have a more comprehensive view of the private fund universe and the investment advisers managing those assets.

- In June 2011, the Commission adopted rules that require the registration of, and reporting by, advisers to hedge funds and other private funds and other advisers previously exempt from SEC registration. As a result, the number of private fund advisers registered with the Commission—advisers that manage one or more private funds—increased significantly. As of January 2, 2013, the number of SEC-registered private fund advisers had increased by more than 50 percent from the effective date of the Dodd-Frank Act to 4,020 advisers. These advisers now represent approximately 37 percent of all SEC-registered investment advisers and collectively manage over 24,000 private funds with total assets of $8 trillion. [3]
- Concurrently, the Commission adopted rules to implement new adviser registration exemptions created by the Dodd-Frank Act. The new rules implement exemptions for: (i) advisers solely to venture capital funds; (ii) advisers solely to private funds with less than $150 million in assets under management in the United States; and (iii) certain foreign advisers without a place of business in the U.S. and with only de minimis U.S. business. [4]
- These new rules also implement the Dodd-Frank requirement for public reporting by investment advisers to venture capital funds and others that are exempt from SEC registration.
- The rules also reallocate regulatory responsibility to State securities authorities for advisers with between $25 million and $100 million in assets under management. [5] To facilitate the reallocation of regulatory responsibility, the Commission issued an order in February 2013 canceling the registrations of certain SEC-registered investment advisers no longer eligible to remain registered. [6]
- In June 2012, the Commission also adopted a new rule defining "family offices," a group that historically has not been required to register as advisers and that is now excluded by rule from the Investment Advisers Act of 1940 (Advisers Act) definition of an investment adviser. [7]
- In February 2012, the Commission adopted amendments to the rule that permits investment advisers to charge performance fees to "qualified clients." [8] The amendments codified the Commission's 2011 inflation adjustments to the net worth and assets-under-management thresholds that clients must satisfy for the adviser to charge these fees. The amendments also excluded the value of a person's primary residence from the rule's net worth test and provided that, as required by the Dodd-Frank Act, the Commission will issue an order every 5 years adjusting the rule's dollar amount thresholds for inflation.

Since the Act became effective, approximately 2,250 formerly SEC registered advisers have transitioned to State registration and approximately 1,500 advisers to hedge funds and private equity funds have registered with the Commission. These

[3] For more information on investment advisers registered with the Commission and advisers required to report information to the Commission after the Dodd-Frank Act, as well as the private funds they manage, *see,* "Dodd-Frank Act Changes to Investment Adviser Registration Requirements", *http://www.sec.gov/divisions/investment/imissues/df-iaregistration.pdf.*

[4] *See,* Release No. IA-3222 "Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers" (June 22, 2011), *http://www.sec.gov/rules/final/2011/IA-3222.pdf.*

[5] *See,* Release No. IA-3221, "Rules Implementing Amendments to the Investment Advisers Act" (June 22, 2011), *http://www.sec.gov/rules/final/2011/ia-3221.pdf.*

[6] *See,* Release No. IA-3547, "Order Cancelling Registrations of Certain Investment Advisers Pursuant to Section 203(h) of the Investment Advisers Act of 1940" (February 6, 2013), *http://www.sec.gov/rules/other/2013/ia-3547.pdf.*

[7] *See,* Release No. IA-3220, "Family Offices" (June 22, 2011), *http://www.sec.gov/rules/final/ia-3220.pdf.*

[8] *See,* Release No. IA-3372, "Investment Adviser Performance Compensation" (February 15, 2012), *http://www.sec.gov/rules/final/2012/ia-3372.pdf.*

new adviser registrants report over $3 trillion in assets under management, while those that transitioned to State registration manage about $115 billion. Most of these new registrants had never been registered, regulated, or examined and many have complex business models, investment programs and trading strategies. Commission staff, through our National Exam Program, has developed and begun implementing a program for these new advisers which includes outreach, examination, and, ultimately, where appropriate, written reports highlighting exam findings.

Whistleblower Program

Pursuant to Section 922 of the Dodd-Frank Act, the SEC established a whistleblower program to pay awards to eligible whistleblowers that voluntarily provide the agency with original information about a violation of the Federal securities laws that leads to a successful SEC enforcement action. The SEC's Office of the Whistleblower filed its second Annual Report to Congress on November 15, 2012, detailing the Office's activities during the fiscal year.[9] As detailed in the Annual Report, during fiscal year 2012 the Commission received 3,001 tips from whistleblowers in the U.S. and 49 other countries. Among other things, the Office (1) regularly communicates with whistleblowers, returning over 3,050 phone calls to the public hotline during fiscal year 2012; (2) identifies and tracks whistleblower tips that may lead to enforcement actions; (3) reviews and processes applications for whistleblower awards; (4) facilitates meetings between whistleblowers and SEC Enforcement staff; and (5) provides extensive guidance to Enforcement staff on various aspects of the program, including proper handling of confidential whistleblower identifying information.

The high quality information that we have been receiving from whistleblowers has, in many instances, allowed our investigative staff to work more efficiently and permitted us to better utilize agency resources.

In August, 2012, the Commission made its first award under the whistleblower program.[10] We expect future payments to further increase the visibility and effectiveness of this important Enforcement initiative.

OTC Derivatives

Among the key provisions of the Dodd-Frank Act are those that establish a new oversight regime for the over-the-counter (OTC) derivatives marketplace. Title VII of the Act requires the Commission to regulate "security-based swaps" and to write rules that address, among other things, mandatory clearing, reporting and trade execution, the operation of clearing agencies, data repositories and trade execution facilities, capital and margin requirements and business conduct standards for dealers and major market participants, and public transparency for transactional information. Among other things, such rules are intended to:

- Facilitate the centralized clearing of swaps, with the intent of reducing counterparty and systemic risk;
- Increase market transparency;
- Increase security-based swap transaction disclosure; and
- Address potential conflict of issues relating to security-based swaps.

Title VII Implementation Generally

The Commission has proposed substantially all of the core rules required by Title VII. In addition, the Commission has adopted a number of final rules and interpretations, provided a "roadmap" to implementation of Title VII, and taken other actions to provide legal certainty to market participants during the implementation process. In implementing Title VII, Commission staff is in regular contact with the staffs of the CFTC, the Board of Governors of the Federal Reserve System (Board), and other Federal financial regulators, and in particular has consulted and coordinated extensively with CFTC staff.

[9] "Annual Report on the Dodd-Frank Whistleblower Program Fiscal 2012" (November 2012), *http://www.sec.gov/about/offices/owb/annual-report-2012.pdf.*

[10] A whistleblower who helped the Commission stop a multimillion dollar fraud received an award of 30 percent of the amount collected in the Commission's enforcement action against the perpetrators of the scheme, the maximum amount permitted by the Act. The award recipient in this matter submitted a tip concerning the fraud and then provided documents and other significant information that allowed the Commission's investigation to move at an accelerated pace and ultimately led to the filing of an emergency action in Federal court to prevent the defendants from ensnaring additional victims and further dissipating investor funds. *See,* "In the Matter of the Claim for Award", Release No. 34-67698 (August 21, 2012), *http://www.sec.gov/rules/other/2012/34-67698.pdf,* and "In the Matter of the Claim for Award", SEC Release No. 34-67699 (August 21, 2012), *http://www.sec.gov/rules/other/2012/34-67699.pdf.*

Adoption of Key Definitional Rules

In July 2012, the Commission adopted final rules and interpretations jointly with the CFTC regarding key product definitions under Title VII.[11] This effort follows the Commission's work on the entity definitions rules, which the Commission adopted jointly with the CFTC in April 2012.[12] The completions of these joint rulemakings are foundational steps toward the complete implementation of Title VII.

The July joint rulemaking addressed certain product definitions and further defined the key terms "swap," "security-based swap," and "security-based swap agreement." It also adopted rules regarding the regulation of "mixed swaps" and the books and records requirements for security-based swap agreements. The April joint rulemaking further defined the key terms "swap dealer" and "security-based swap dealer," providing guidance as to what constitutes dealing activity, and distinguishing dealing from nondealing activities such as hedging. The rulemaking also implemented the Dodd-Frank Act's statutory de minimis exception to the security-based swap dealer definition in a way tailored to reflect the different types of security-based swaps. Additionally, the rulemaking implemented the Dodd-Frank Act's "major security-based swap participant" definition through the use of three objective tests.

While foundational, these final rules did not trigger compliance with the other rules the Commission is adopting under Title VII. Instead, the compliance dates applicable to each final rule will be set forth in the adopting release for the applicable rule. In this way, the Commission is better able to provide for an orderly implementation of the various Title VII rules.

Adoption of Rules and Other Action Related to Clearing

In addition to the key definitional rules, the Commission has adopted rules under Title VII relating to clearing infrastructure. In October 2012, the Commission adopted a rule that establishes operational and risk management standards for clearing agencies, including clearing agencies that clear security-based swaps.[13] The rule, discussed in more detail below, is designed to help ensure that clearing agencies will be able to fulfill their responsibilities in the multitrillion dollar derivatives market as well as in more traditional securities markets.

In June 2012, the Commission adopted rules that establish procedures for its review of certain actions undertaken by clearing agencies.[14] These rules detail how clearing agencies will provide information to the Commission about the security-based swaps the clearing agencies plan to accept for clearing, which will then be used by the Commission to aid in determining whether those security-based swaps are required to be cleared. The adopted rules also include rules requiring clearing agencies that are designated as "systemically important" under Title VIII of the Dodd-Frank Act to submit advance notice of changes to their rules, procedures, or operations if the changes could materially affect the nature or level of risk at those clearing agencies.

In addition, in December 2012, the Commission issued an order providing exemptive relief in connection with a program to commingle and portfolio margin customer positions in cleared credit default swaps which include both swaps and security-based swaps.[15] Portfolio margining may be of benefit to investors and the market by, among other things, promoting greater efficiency in clearing, helping to alleviate excessive margin calls, improving cash flow and liquidity, and reducing volatility. Previously, in March 2012, the Commission had adopted rules providing exemptions under the Securities Act of 1933 (Securities Act), the Securities Exchange Act of

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[11] *See,* Release No. 33-9338, "Further Definition of 'Swap', 'Security-Based Swap', and 'Security-Based Swap Agreement'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping" (July 18, 2012) *http://www.sec.gov/rules/final/2012/33-9338.pdf.*

[12] *See,* Release No. 34-66868, "Further Definition of 'Swap Dealer', 'Security-Based Swap Dealer', 'Major Swap Participant', 'Major Security-Based Swap Participant', and 'Eligible Contract Participant'" (April 27, 2012) *http://www.sec.gov/rules/final/2012/34-66868.pdf.*

[13] *See,* Release No. 34-68080, "Clearing Agency Standards" (October 22, 2012), *http://www.sec.gov/rules/final/2012/34-68080.pdf.*

[14] *See,* Release No. 34-67286, "Process for Submissions for Review of Security-Based Swaps for Mandatory Clearing and Notice Filing Requirements for Clearing Agencies; Technical Amendments to Rule 19b-4 and Form 19b-4 Applicable to All Self-Regulatory Organizations" (June 28, 2012), *http://www.sec.gov/rules/final/2012/34-67286.pdf.*

[15] *See,* Release No. 34-68433, "Order Granting Conditional Exemptions Under the Securities Exchange Act of 1934 in connection with Portfolio Margining of Swaps and Security-Based Swaps" (December 14, 2012), *http://sec.gov/rules/exorders/2012/34-68433.pdf.*

1934 (Exchange Act), and the Trust Indenture Act of 1939 for security-based swaps transactions involving certain clearing agencies satisfying certain conditions.[16]

Adoption of Rules Related to Reporting

In 2010, the Commission adopted an interim final temporary rule regarding the reporting of certain information relating to outstanding security-based swap transactions entered into prior to the date of enactment of the Dodd-Frank Act.[17] In 2011, we also readopted certain of our beneficial ownership rules to preserve their application to persons who purchase or sell security-based swaps.[18]

Issuance of Implementation Policy Statement

In addition to its work to propose and adopt Title VII rules, the Commission issued a policy statement in June 2012, describing and requesting public comment on the order in which it expects to require compliance by market participants with the final Title VII rules.[19] The Commission's approach aims to avoid the disruption and cost that could result if compliance with all of the rules were required simultaneously or haphazardly. More generally, the policy statement is part of our overall commitment to making sure that market participants know what the "rules of the road" are before requiring compliance with those rules.

The implementation policy statement is divided into five broad categories of final rules to be adopted by the Commission and explains how the compliance dates of these rules would be sequenced in relative terms by describing the dependencies that exist within and among the categories. The statement emphasizes that those subject to the new regulatory requirements arising from these rules will be given adequate, but not excessive, time to come into compliance with them.

The statement also discusses the timing of the expiration of temporary relief the Commission previously granted security-based swap market participants from certain provisions of the Federal securities laws. The expiration of much of this relief is tied to the effective or compliance dates of certain rules to be adopted pursuant to Title VII.

Market participants have provided comments on the sequencing set out in the policy statement, and we are taking those into account as we work toward completing the Title VII adoption process.

Provision of Legal Certainty

Consistent with our commitment to an orderly Title VII implementation process, the Commission has taken a number of steps to provide legal certainty and avoid unnecessary market disruption that might otherwise have arisen as a result of final rules not having been adopted by the July 16, 2011, effective date of Title VII. Specifically, we have:

- Provided guidance regarding which provisions in Title VII governing security-based swaps became operable as of the effective date and provided temporary relief from several of these provisions;[20]
- Provided guidance regarding—and, where appropriate, interim exemptions from—the various pre- Dodd-Frank provisions that otherwise would have applied to security-based swaps on July 16, 2011;[21] and

[16] *See,* Release No. 33-9308, "Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies" (March 30, 2012), *http://www.sec.gov/rules/final/2012/33-9308.pdf.*

[17] *See,* Release No. 34-63094, "Reporting of Security-Based Swap Transaction Data" (October 13, 2010), *http://www.sec.gov/rules/interim/2010/34-63094.pdf.*

[18] *See,* Release No. 34-64628, "Beneficial Ownership Reporting Requirements and Security-Based Swaps" (June 8, 2011), *http://www.sec.gov/rules/final/2011/34-64628.pdf.*

[19] *See,* Release No. 34-37177, "Statement of General Policy on the Sequencing of the Compliance Dates for Rules Applicable to Security-Based Swaps" (June 11, 2012), *http://www.sec.gov/rules/policy/2012/34-67177.pdf.*

[20] *See,* Release No. 34-64678, "Temporary Exemptions and Other Temporary Relief, Together With Information on Compliance Dates for New Provisions of the Securities Exchange Act of 1934 Applicable to Security-Based Swaps" (June 15, 2011), *http://www.sec.gov/rules/exorders/2011/34-64678.pdf.*

[21] *See,* Release No. 34-64795, "Order Granting Temporary Exemptions Under the Securities Exchange Act of 1934 in Connection with the Pending Revision of the Definition of 'Security' to Encompass Security-Based Swaps, and Request for Comment" (July 1, 2011), *http://sec.gov/rules/exorders/2011/34-64795.pdf;* Release No. 33-9231, "Exemptions for Security-Based Swaps" (July 1, 2011), *http://www.sec.gov/rules/interim/2011/33-9231.pdf;* and Release No. 33-9383, "Extension of Exemptions for Security-Based Swaps" (January 29, 2013), *http://www.sec.gov/rules/interim/2013/33-9383.pdf.*

- Provided temporary relief for entities providing certain clearing services for security-based swaps.[22]

Next Steps for Implementation of Title VII: Application of Title VII in the Cross-Border Context

With very limited exceptions, the Commission has not addressed the application of the security-based swap provisions of Title VII in the cross-border context in its proposed or final rules. Rather than addressing these issues in a piecemeal fashion through each of the various substantive rulemakings implementing Title VII, we instead plan to address them holistically in a single proposing release. We believe this approach will provide investors, market participants, foreign regulators, and other interested parties with the opportunity to consider, as an integrated whole, the Commission's proposed approach to the application of the security-based swap provisions of Title VII in the cross-border context.

As we have indicated previously, we expect the scope of the effort to be broad. The proposal will address the application of Title VII in the cross-border context with respect to each of the major registration categories covered by Title VII for security-based swaps: security-based swap dealers; major security-based swap participants; security-based swap clearing agencies; security-based swap data repositories; and security-based swap execution facilities. It also will address the application of Title VII in connection with reporting and dissemination, clearing, and trade execution, as well as the sharing of information with regulators and related preservation of confidentiality with respect to data collected and maintained by security-based swap data repositories.

The cross-border release will involve notice-and-comment rulemaking, not just interpretive guidance. As a rulemaking proposal, the release will consider investor protection and incorporate an economic analysis that considers, among other things, the effects of the proposal on efficiency, competition, and capital formation. Although the rulemaking approach takes more time, we believe there are a number of benefits to this approach, including the opportunity to benefit from public input and the opportunity to provide a full articulation of the rationales for, and consideration of reasonable alternatives to, particular approaches that achieve the statutory purpose.

The Dodd-Frank Act specifically requires that the Commission, the CFTC, and the prudential regulators "consult and coordinate with foreign regulatory authorities on the establishment of consistent international standards" with respect to the regulation of OTC derivatives. The Commission has been actively working on a bilateral and multilateral basis with our fellow regulators abroad in such groups as the International Organization of Securities Commissions, the Financial Stability Board, and the OTC Derivatives Regulators Group, as we develop our proposed approach to cross-border issues under Title VII. Through these discussions and our participation in various international task forces and working groups, we also have gathered extensive information about foreign regulatory reform efforts, identified potential gaps, overlaps, and conflicts between U.S. and foreign regulatory regimes, and encouraged foreign regulators to develop rules and standards complementary to our own under the Dodd-Frank Act.

Additional Steps

In addition to proposing rules and interpretive guidance addressing the international implications of Title VII, the Commission expects to propose rules relating to books and records and reporting requirements for security-based swap dealers and major security-based swap participants. The Commission also expects soon to consider the application of mandatory clearing requirements to single-name credit default swaps, starting with those that were first cleared prior to the enactment of the Dodd-Frank Act.

Finally, the Commission staff continues to work diligently to develop recommendations for final rules required by Title VII that have been proposed but not yet been adopted, including rules relating to:

- Security-Based Swap Dealers and Major Security-Based Swap Participant Requirements;[23]

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[22] *See,* Release No. 34-64796, "Order Pursuant to Section 36 of the Securities Exchange Act of 1934 Granting Temporary Exemptions From Clearing Agency Registration Requirements Under Section 17A(b) of the Exchange Act for Entities Providing Certain Clearing Services for Security-Based Swaps" (July 1, 2011), *http://sec.gov/rules/exorders/2011/34-64796.pdf.*

[23] *See,* Release No. 34-65543, "Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants" (October 12, 2011), *http://www.sec.gov/rules/proposed/2011/34-65543.pdf;* Release No. 34-68071, "Capital, Margin, and Segregation Requirements for Security-

- Regulatory Reporting and Post-Trade Public Transparency;[24]
- Mandatory Clearing and Trade Execution and the Regulation of Clearing Agencies and Security-Based Swap Execution Facilities;[25] and
- Enforcement and Market Integrity.[26]

Clearing Agencies

Title VIII of the Dodd-Frank Act provides for increased regulation of financial market utilities[27] (FMUs) and financial institutions that engage in payment, clearing, and settlement activities that are designated as systemically important. The purpose of Title VIII is to mitigate systemic risk in the financial system and promote financial stability. In addition, Title VII of the Dodd-Frank Act requires, among other things, that an entity acting as a clearing agency with respect to security-based swaps register with the Commission and that the Commission adopt rules with respect to clearing agencies that clear security-based swaps.

Adoption of Clearing Agency Standards

Clearing agencies play a critical role in the financial markets by ensuring that transactions settle on time and on agreed-upon terms. To promote the integrity of clearing agency operations and governance, the Commission adopted rules requiring all registered clearing agencies to maintain certain standards with respect to risk management and certain operational matters.[28] The rules also contain specific requirements for clearing agencies that perform central counterparty services. For example, such clearing agencies must have in place written policies and procedures reasonably designed to:

- Measure their credit exposures to participants at least once a day;
- Use margin requirements to limit their credit exposures to participants, to be reviewed at least monthly;
- Maintain sufficient financial resources to withstand, at a minimum, a default by the participant family to which the clearing agency has the largest exposure in extreme but plausible market conditions (with a higher requirement that agencies clearing security-based swaps maintain sufficient resources to cover the two largest participant family exposures); and
- Provide the opportunity to obtain membership in the clearing agency for persons who are not dealers or security-based swap dealers on fair and reasonable terms.

The rules also establish record keeping and financial disclosure requirements for all registered clearing agencies as well as several new standards for clearance and settlement.

Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers" (October 18, 2012), *http://www.sec.gov/rules/proposed/2012/34-68071.pdf;* Release No. 34-64766, "Business Conduct Standards for Security-Based Swaps Dealer and Major Security-Based Swap Participants" (June 29, 2011), *http://www.sec.gov/rules/proposed/2011/34-64766.pdf;* and Release No. 34-63727, "Trade Acknowledgment and Verification on Security-Based Swap Transactions" (January 14, 2011), *http://www.sec.gov/rules/proposed/2011/34-63727.pdf.*

[24] *See,* Release No. 34-63346, "Regulation SBSR—Reporting and Dissemination of Security-Based Swap Information" (November 19, 2010), *http://www.sec.gov/rules/proposed/2010/34-63346.pdf;* and Release No. 34-63347, "Security-Based Swap Data Repository Registration, Duties, and Core Principles" (November 19, 2010), *http://www.sec.gov/rules/proposed/2010/34-63347.pdf.*

[25] *See,* Release No. 34-63556, "End-User Exception of Mandatory Clearing of Security-Based Swaps" (December 15, 2010), *http://www.sec.gov/rules/proposed/2010/34-63556.pdf;* Release No. 34-63107, "Ownership Limitations and Governance Requirements for Security-Based Swap Clearing Agencies, Security-Based Swap Execution Facilities, and National Securities Exchanges with Respect to Security-Based Swaps under Regulation MC" (October 14, 2010), *http://www.sec.gov/rules/proposed/2010/34-63107.pdf;* and "Registration and Regulation of Security-Based Swap Execution Facilities" (February 2, 2011), *http://www.sec.gov/rules/proposed/2011/34-63825.pdf.*

[26] *See,* Release No. 34-63236, "Prohibition Against Fraud, Manipulation, and Deception in Connection with Security-Based Swaps" (November 3, 2010), *http://www.sec.gov/rules/proposed/2010/34-63236.pdf.*

[27] Section 803(6) of the Dodd-Frank Act defines a financial market utility as "any person that manages or operates a multilateral system for the purpose of transferring, clearing, or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the person."

[28] *See,* Release No. 34-68080, "Clearing Agency Standards" (October 22, 2012), *http://www.sec.gov/rules/final/2012/34-68080.pdf.*

The new rules were the result of close work between the Commission staff and staffs of the CFTC and the Board. The requirements take into consideration recognized international standards, and they are designed to further strengthen the Commission's oversight of securities clearing agencies, promote consistency in the regulation of clearing organizations generally, and thereby help to ensure that clearing agency regulation reduces systemic risk in the financial markets.

Systemically Important Clearing Agencies

SEC staff has worked with colleagues at the CFTC, the Board, the Department of Treasury, and other U.S. financial agencies on the designation of certain clearing agencies as systemically important FMUs. Title VIII of the Dodd-Frank Act provides important new enhancements to the regulation and supervision of designated FMUs that are designed to provide consistency, promote robust risk management and safety and soundness, reduce systemic risks, and support the stability of the broader financial system. [29]

Under Title VIII, FSOC is authorized to designate an FMU as systemically important if the failure or a disruption to the functioning of the FMU could create or increase the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the U.S. financial system. Since FSOC established an interagency FMU designations committee to develop a framework for the designation of systemically important FMUs, SEC staff has actively participated in the designations committee. In July 2012, FSOC designated six clearing agencies registered with the Commission as systemically important FMUs under Title VIII. [30] The SEC staff played an important role in preparing the analysis that provided the basis for these designations.

In addition, as directed by Title VIII and prior to the completion of the designation process, the SEC staff worked jointly with the staffs of the CFTC and the Board to develop a report to Congress containing recommendations regarding risk management supervision of clearing entities designated as systemically important. The staffs of the agencies met regularly to develop a framework for (1) improving consistency in the clearing entity oversight programs of the SEC and CFTC; (2) promoting robust risk management by designated clearing agencies; and (3) improving regulators' ability to monitor the potential effects of such risk management on the stability of the U.S. financial system. The joint report was submitted to Congress in July 2011. [31] Consistent with the framework set out in the report, the SEC has been engaged in ongoing consultation and cooperation in clearing agency oversight with the staffs of the CFTC and the Board.

Staff Studies Regarding Investment Advisers and Broker-Dealers

In January 2011, the Commission submitted to Congress two staff studies in the investment management area required by the Dodd-Frank Act.

The first study, mandated by Section 914, analyzed the need for enhanced examination and enforcement resources for investment advisers registered with the Commission. [32] It found that the Commission likely will not have sufficient capacity in the near or long term to conduct effective examinations of registered investment advisers with adequate frequency. Therefore, the study stated that the Commission's examination program requires a source of funding adequate to permit the Commission to meet new examination challenges and sufficiently stable to prevent adviser examination resources from continuously being outstripped by growth in the number of registered investment advisers.

The study outlined the following three options for strengthening the Commission's investment adviser examination program: (1) imposing user fees on Commission-registered investment advisers to fund their examinations; (2) authorizing one or more self-regulatory organizations that assess fees on their members to examine, subject to Commission oversight, all Commission-registered investment advisers; or (3) au-

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[29] *See,* Dodd-Frank Act §802.

[30] Clearing agencies that have been designated systemically important are Chicago Mercantile Exchange, Inc., The Depository Trust Company, Fixed Income Clearing Corporation, ICE Clear Credit LLC, National Securities Clearing Corporation, and The Options Clearing Corporation. Two payment systems were also designated systemically important: The Clearing House Payments Company L.L.C. on the basis of its role as operation of the Clearing House Interbank Payments System and CLS Bank International.

[31] "Risk Management Supervision of Designated Clearing Entities", *http://www.sec.gov/news/studies/2011/813study.pdf.*

[32] *See,* "Study on Enhancing Investor Adviser Examinations" (January 2011), *http://www.sec.gov/news/studies/2011/914studyfinal.pdf; see also,* Commissioner Elisse B. Walter, Statement on Study Enhancing Investment Adviser Examinations (Required by Section 914 of Title IX of the Dodd-Frank Wall Street Reform and Consumer Protection Act) (Jan. 2010), *http://www.sec.gov/news/speech/2011/spch011911ebw.pdf.*

thorizing FINRA to examine a subset of advisers—specifically, dually registered investment advisers and broker-dealers—for compliance with the Advisers Act.

The second staff study, required by Section 913 of the Dodd-Frank Act (the "IA/BD Study"), addressed the obligations of investment advisers and broker-dealers when providing personalized investment advice about securities to retail customers.[33] The staff study noted that retail investors generally are not aware of the differences between the regulation of investment advisers and broker-dealers, or the legal implications of those differences. The staff study also noted that many investors are confused by the different standards of care that apply to investment advisers and broker-dealers. The IA/BD Study made two primary recommendations: that the Commission (1) exercise the discretionary rulemaking authority provided by Section 913 of the Dodd-Frank Act to implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when they are providing personalized investment advice about securities to retail investors; and (2) consider harmonization of broker-dealer and investment adviser regulation when broker-dealers and investment advisers provide the same or substantially similar services to retail investors and when such harmonization adds meaningfully to investor protection.

Under Section 913, the uniform fiduciary standard to which broker-dealers and investment advisers would be subject would be "to act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice." The uniform fiduciary standard would be "no less stringent" than the standard that applies to investment advisers today.

We are giving serious consideration to the study's recommendations. Since publishing the IA/BD Study, the staff, including the Commission's economists, continues to review current information and available data about the marketplace for personalized investment advice and the potential impact of the study's recommendations. While we have extensive experience in the regulation of broker-dealers and investment advisers, we believe the public can provide further data and other information to assist us in determining whether or not to adopt a uniform fiduciary standard of conduct or otherwise use the authority provided under Section 913 of the Dodd-Frank Act. To this end, the staff is drafting a public request for information to obtain data specific to the provision of retail financial advice and the regulatory alternatives. The request aims to seek information from commenters—including retail investors, as well as industry participants—that will be helpful to us as we continue to analyze the various components of the market for retail financial advice.

Credit Rating Agencies

Under the Dodd-Frank Act, the Commission is required to undertake approximately a dozen rulemakings related to nationally recognized statistical rating organizations (NRSROs). The Act requires the SEC to address, among other things, internal controls and procedures, conflicts of interest, credit rating methodologies, transparency, ratings performance, analyst training, credit rating symbols and definitions, and disclosures accompanying the publication of credit ratings. The Commission adopted the first of these required rulemakings in January 2011,[34] and in May 2011 published for public comment a series of proposed rules that would further implement this requirement.[35] The proposed rules are intended to strengthen the integrity of credit ratings by, among other things, improving their transparency. Under the Commission's proposals, NRSROs would, among other things, be required to:

- Report on their internal controls;
- Better protect against conflicts of interest;
- Establish professional standards for their credit analysts;

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[33] *See,* "Study on Investment Advisers and Broker-Dealers" (January 2011), *http://www.sec.gov/news/studies/2011/913studyfinal.pdf; see also,* Statement by SEC Commissioners Kathleen L. Casey and Troy A. Paredes Regarding Study on Investment Advisers and Broker-Dealers (January 21, 2011), *http://www.sec.gov/news/speech/2011/spch012211klctap.htm.*

[34] *See,* Release No. 33-9175, "Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (January 20, 2011), *http://www.sec.gov/rules/final/2011/33-9175.pdf.* In addition, in September 2010, the Commission issued an amendment to Regulation FD that implements Section 939B of the Act, which requires that the SEC amend Regulation FD to remove the specific exemption from the rule for disclosures made to NRSROs and credit rating agencies for the purpose of determining or monitoring credit ratings. *See,* Release No. 33-9146, "Removal From Regulation FD of the Exemption for Credit Rating Agencies" (September 29, 2010), *http://www.sec.gov/rules/final/2010/33-9146.pdf.*

[35] *See,* Release No. 34-64514, "Proposed Rules for Nationally Recognized Statistical Rating Organizations" (May 18, 2011), *http://www.sec.gov/rules/proposed/2011/34-64514.pdf.*

- Provide, along with the publication of any credit rating, public disclosure about the credit rating and the methodology used to determine it; and
- Provide enhanced public disclosures about the performance of their credit ratings.

The Dodd-Frank Act also mandated three studies relating to credit rating agencies: (1) a study on the feasibility and desirability of standardizing credit rating terminology, which was published in September 2012;[36] (2) a study on alternative compensation models for rating structured finance products, which was published in December 2012;[37] and (3) a study on NRSRO independence, which the Commission staff is actively developing and which is due in July 2013.[38]

The Act also requires every Federal agency to review its regulations that require use of credit ratings as an assessment of the credit-worthiness of a security and undertake rulemakings to remove these references and replace them with other standards of creditworthiness deemed appropriate. In July 2011, the staff published a report discussing the following steps the Commission has taken to fulfill this requirement:[39]

- In July 2011, the Commission adopted rule amendments removing credit ratings as conditions for companies seeking to use short-form registration when registering nonconvertible securities for public sale.[40] In addition, prior to adoption of the Act, in April 2010, the Commission proposed new requirements to replace the current credit rating references in shelf eligibility criteria for asset-backed security issuers with new shelf eligibility criteria.[41] In light of the Act and comment received on the April 2010 proposal, in July 2011, the Commission reproposed the shelf eligibility criteria for offerings of asset-backed securities.
- In April 2011, the Commission proposed removing references to credit ratings in rules concerning broker-dealer financial responsibility, distributions of securities, and confirmations of transactions.[42] Also, in July 2012, the Commission issued an Interpretive Release in response to Section 939(e) of the Dodd-Frank Act, which removes references to credit ratings by NRSROs in two definitions in the Exchange Act.[43]
- In March 2011, the Commission proposed to remove credit ratings from rules relating to the types of securities in which a money market fund can invest and the treatment of repurchase agreements for certain purposes under the Investment Company Act as well as from the disclosure forms that certain investment companies must use.[44]

In September 2010, the Commission also adopted a rule amendment removing communications with credit rating agencies from the list of excepted communications in Regulation FD, as required by Section 939B of the Dodd-Frank Act.[45]

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[36] "Credit Rating Standardization Study" (September 2012), *http://www.sec.gov/news/studies/2012/939h_credit_rating_standardization.pdf.*

[37] "Report to Congress on Assigned Credit Ratings" (December 2012), *http://www.sec.gov/news/studies/2012/assigned-credit-ratings-study.pdf.* The staff is currently in the process of organizing a public roundtable to invite discussion from proponents and critics of the three courses of action discussed in the report.

[38] *See,* Dodd-Frank Act §939C.

[39] "Report on Review of Reliance on Credit Ratings" (July 2011), *http://www.sec.gov/news/studies/2011/939astudy.pdf.*

[40] *See,* Release No. 33-9245, "Security Ratings" (July 27, 2011), *http://www.sec.gov/rules/final/2011/33-9245.pdf.*

[41] *See,* Release No. 33-9117, "Asset-Backed Securities" (April 7, 2010), *http://www.sec.gov/rules/proposed/2010/33-9117.pdf.*

[42] *See,* Release No. 34-64352, "Removal of Certain References to Credit Ratings Under the Securities Exchange Act of 1934" (April 27, 2011), *http://www.sec.gov/rules/proposed/2011/34-64352.pdf.*

[43] *See,* Release No. 34-67448, "Commission Guidance Regarding Definitions of Mortgage Related Security and Small Business Related Security" (July 17, 2012), *http://www.sec.gov/rules/interp/2012/34-67448.pdf.*

[44] *See,* Release Nos. 33-9193; IC-29592, "References to Credit Ratings in Certain Investment Company Act Rules and Forms" (March 3, 2011), *http://www.sec.gov/rules/proposed/2011/33-9193.pdf.* In addition, in November 2012, the Commission adopted a rule establishing a credit quality standard that certain investments by business and industrial development companies must satisfy for those companies to qualify for an exemption from most provisions of the Investment Company Act. "Purchase of Certain Debt Securities by Business and Industrial Development Companies Relying on an Investment Company Act Exception" (November 19, 2012), *http://www.sec.gov/rules/final/2012/ic-30268.pdf.*

[45] *See,* Release No. 33-9146, "Removal From Regulation FD of the Exemption for Credit Rating Agencies" (September 29, 2010), *http://www.sec.gov/rules/final/2010/33-9146.pdf.*

Finally, the Dodd-Frank Act requires the Commission to conduct staff examinations of each NRSRO at least annually and to issue an annual report summarizing the exam findings. As discussed in greater detail below, our staff recently completed the second cycle of these exams, and, following approval by the Commission, the staff's summary report of the examinations was published in November 2012.[46] The staff will continue to focus on completing the statutorily mandated annual examinations of each NRSRO, including follow-up from prior examinations, and making public the summary report of those examinations to promote compliance with statutory and Commission requirements. It also is taking steps in response to a recent International Organization of Securities Commissions preliminary recommendation to establish "colleges" of regulators to provide a framework for information exchange and collaboration with foreign counterparts regarding large globally active credit rating agencies.[47]

Volcker Rule

In October 2011, the Commission proposed a rule jointly with the Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (collectively, the "Federal banking agencies") to implement Section 619 of the Dodd-Frank Act, commonly referred to as the "Volcker Rule."[48] This proposal reflects an extensive, collaborative effort among the Federal banking agencies, the SEC, and the CFTC, under the coordination of the Department of the Treasury (Treasury), to design a rule to implement the Volcker Rule's prohibitions and restrictions in a manner that is consistent with the language and purpose of the statute.[49]

As required by Section 619, the joint proposal generally prohibits banking entities—including bank-affiliated, SEC-registered broker-dealers, security-based swap dealers, and investment advisers—from engaging in proprietary trading and having certain interests in, and relationships with, hedge funds and private equity funds (covered funds).[50] Like the statute, the proposed rule provides certain exceptions to these general prohibitions. For example, the proposal permits a banking entity to engage in underwriting, market making-related activity, risk-mitigating hedging, and organizing and offering a covered fund, among other permitted activities, provided that specific requirements are met. Further, consistent with the statute, an otherwise-permitted activity would be prohibited if it involved a material conflict of interest, high-risk assets or trading strategies, or a threat to the safety and soundness of the banking entity or to the financial stability of the United States. As set forth in the Dodd-Frank Act, the Commission's rule would apply to banking entities for which the Commission is the primary financial regulatory agency, including, among others, certain SEC-registered broker-dealers, investment advisers, and security-based swap dealers.

The joint proposal sought comment on a wide range of topics due, in part, to the breadth of issues presented by the statute and the proposal. In response, the Commission has received nearly 19,000 comment letters, including more than 600 unique and detailed letters.[51] These comments represent a wide variety of view-

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[46] "2012 Summary Report of Commission Staff's Examinations of Each Nationally Recognized Statistical Rating Organization" (November 2012), *http://www.sec.gov/news/studies/2012/nrsro-summary-report-2012.pdf.*

[47] *See,* Release No. IOSCO/MR/34/2012, "IOSCO Publishes Two Reports Advancing Its Work on Credit Rating Agencies" (Dec. 21, 2012) *http://www.iosco.org/news/pdf/IOSCONEWS261.pdf.*

[48] *See,* Release No. 34-65545, "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds" (October 12, 2011), *http://www.sec.gov/rules/proposed/2011/34-65545.pdf*. The CFTC issued a substantially similar proposal in January 2012, which was published in the *Federal Register* in February 2012. *See,* 77 FR 8332 (February 14, 2012), *http://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2012-935.*

[49] In developing this proposal, interagency staffs gave close and thoughtful consideration to the FSOC's January 2011 study and its recommendations for implementing Section 619, which can be found at *http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf*. As a result, the joint proposal builds upon many of the recommendations set forth in the FSOC study.

[50] Section 619 defines "banking entity" as any insured depository institution (other than certain limited purpose trust institutions), any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978 (i.e., a foreign entity with a branch, agency, or subsidiary bank operation in the U.S.), and any affiliate or subsidiary of any of the foregoing entities. *See,* 12 U.S.C. 1851(h)(1).

[51] The Commission and the Federal banking agencies extended the comment period for the joint proposal from January 13, 2012 to February 13, 2012. *See,* Release No. 34-66057 (Decem-

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points on a number of complex topics, and we are closely considering them as we continue to work with the Federal banking agencies, the CFTC, and Treasury to develop rules to implement Section 619. Staffs from each of the regulatory agencies and Treasury are engaged in regular and active consultation to determine how best to move forward to implement the statute.

Pursuant to the Dodd-Frank Act, the statutory requirements of Section 619 became effective on July 21, 2012. However, the statute also provides for a conformance period following the effective date. Section 619 authorizes the Board to establish rules regarding the conformance period. The Board issued a conformance rule in February 2011[52] and a related policy statement in April 2012, which confirmed that banking entities have 2 years, beginning July 21, 2012, to conform all of their activities and investments to the requirements of Section 619, unless the Board extends the conformance period.[53]

Municipal Advisors

Section 975 of the Dodd-Frank Act creates a new class of regulated persons, "municipal advisors," and requires these advisors to register with the Commission. This new registration requirement, which became effective on October 1, 2010, makes it unlawful for any municipal advisor, among other things, to provide advice to a municipal entity unless the advisor is registered with the Commission. In September 2010, the Commission adopted, and subsequently extended, an interim final rule establishing a temporary means for municipal advisors to satisfy the registration requirement.[54] The Commission has received over 1,100 confirmed registrations of municipal advisors pursuant to this temporary rule.

In December 2010, the Commission proposed a permanent rule to govern municipal advisor registration with the SEC.[55] We have received over 1,000 comment letters on the proposal. Many expressed concern that the proposed rules were overbroad in various respects, including their potential impact on appointed board members of municipal entities, municipal investments unrelated to municipal securities, and traditional banking products and services.

Finalizing the permanent rules for the registration of municipal advisors is now the highest immediate priority of the SEC's newly established Office of Municipal Securities.[56] We anticipate that the final rules would address, among other things, the well-publicized concerns about the need for an exception from registration for appointed board members of municipal entities. In addition, the staff is continuing to discuss many interpretive issues with other regulators and interested market participants in pursuit of a final rule that requires appropriate registration of parties engaging in municipal advisory activities without unnecessarily imposing additional regulation.

Asset-Backed Securities

The Commission has been active in implementing Subtitle D of Title IX of the Dodd-Frank Act, entitled "Improvements to the Asset-Backed Securitization Process". In August 2011, the Commission adopted rules in connection with Section 942(a) of the Act, which eliminated the automatic suspension of the duty to file reports under Section 15(d) of the Exchange Act for asset-backed security (ABS) issuers and granted the Commission authority to issue rules providing for the suspension or termination of this duty to file reports. The new rules permit suspension of the reporting obligations for ABS issuers when there are no longer asset-backed securities of the class sold in a registered transaction held by nonaffiliates of the depositor.[57]

The Commission also is working closely with other regulators to jointly create the risk retention rules required by Section 941 of the Act, which will address the ap-

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ber 23, 2011), *http://www.sec.gov/rules/proposed/2011/34-66057.pdf.* The Commission's public comment file is available at *http://www.sec.gov/comments/s7-41-11/s74111.shtml.*

[52] *See,* 76 FR 8265 (February 14, 2011).

[53] *See,* 77 FR 33949 (June 8, 2012). The Board policy statement further provides that, during the conformance period, banking entities should engage in good-faith planning efforts, appropriate for their activities and investments, to enable them to conform their activities and investments to the requirements of Section 619 and final implementing rules by no later than the end of the conformance period.

[54] *See,* Release No. 34-62824, "Temporary Registration of Municipal Advisors" (September 1, 2010), *http://www.sec.gov/rules/interim/2010/34-62824.pdf.*

[55] *See,* Release No. 34-63576, "Registration of Municipal Advisors" (December 20, 2010), *http://sec.gov/rules/proposed/2010/34-63576.pdf.*

[56] The Office of Municipal Securities is described in more detail below.

[57] *See,* Release No. 34-65148, "Suspension of the Duty to File Reports for Classes of Asset-Backed Securities Under Section 15(d) of the Securities Exchange Act of 1934" (August 17, 2011), *http://www.sec.gov/rules/final/2011/34-65148.pdf.*

propriate amount, form and duration of required risk retention for ABS securitizers and will define qualified residential mortgages (QRMs). On March 30, 2011, the Commission joined its fellow regulators in issuing for public comment proposed risk retention rules to implement Section 941.[58]

Under the proposed rules, a sponsor generally would be permitted to choose from a menu of four risk retention options to satisfy its minimum 5 percent risk retention requirement. These options were designed to provide sponsors with flexibility while also ensuring that they actually retain credit risk to align incentives. The proposed rules also include three transaction-specific options related to securitizations involving revolving asset master trusts, asset-backed commercial paper conduits, and commercial mortgage-backed securities. Also, as required by Section 941, the proposal provides a complete exemption from the risk retention requirements for ABS collateralized solely by QRMs and establishes the terms and conditions under which a residential mortgage would qualify as a QRM. We have received a number of comments regarding the QRM exemption, as well as concerning other aspects of the proposal.[59] The staff currently is considering those comments and diligently working with the other agencies' staff to move forward with this interagency rulemaking.

In January 2011 the Commission also adopted rules on the use of representations and warranties in the market for ABS as required by the Act's Section 943.[60] The rules required ABS issuers to disclose the history of repurchase requests received and repurchases made relating to their outstanding ABS. Issuers were required to make their initial filing on February 14, 2012, disclosing the repurchase history for the 3 years ending December 31, 2011. The disclosure requirements apply to issuers of registered and unregistered ABS, including municipal ABS, though the rules provide municipal ABS an additional 3-year phase-in period.

The Commission also adopted rules in January 2011 to implement Section 945, which required an asset-backed issuer in a Securities Act registered transaction to perform a review of the assets underlying the ABS and disclose the nature of such review.[61] Under the final rules, the type of review conducted may vary, but at a minimum must be designed and effected to provide reasonable assurance that the prospectus disclosure about the assets is accurate in all material respects. The final rule provided a phase-in period to allow market participants to adjust their practices to comply with the new requirements.

Prohibition Against Conflicts of Interest in Certain Securitizations

In September 2011, the Commission proposed a rule to implement the prohibition under Section 621 of the Act, which prohibited entities that create and distribute ABS from engaging in transactions that involve or result in material conflicts of interest with respect to the investors in such ABS.[62] The proposed rule would implement this provision by prohibiting underwriters, placement agents, initial purchasers, sponsors of ABS, or any affiliate or subsidiary of such entity from engaging in any transaction that would involve or result in any material conflicts of interest with respect to any investor in the relevant ABS. These entities, referred to as "securitization participants," assemble, package, and distribute ABS, so they may benefit from the activity that Section 621 is designed to prohibit. The prohibition would apply to both nonsynthetic and synthetic asset-backed securities and would apply to both registered and unregistered offerings of asset-backed securities.

The proposal is not intended to prohibit legitimate securitization activities. We asked many questions in the release to help us strike the right balance of prohib-

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[58] *See,* Release No. 34-64148, "Credit Risk Retention" (March 30, 2011), *http://www.sec.gov/rules/proposed/2011/34-64148.pdf.* Section 941, is codified as the new Section 15G of the Exchange Act. It generally requires the Commission, the Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency and, in the case of the securitization of any "residential mortgage asset," the Federal Housing Finance Agency and Department of Housing and Urban Development, to jointly prescribe regulations that require a securitizer to retain not less than 5 percent of the credit risk of any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party. Section 15G also provides that the jointly prescribed regulations must prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain. *See,* §780-11(c)(1)(A).

[59] The SEC received letters on the proposal from over 10,000 commentators, representing approximately 275 unique comment letters.

[60] *See,* Release No. 33-9175, "Disclosure for Asset-Backed Securities Required by Section 943 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (January 20, 2011), *http://www.sec.gov/rules/final/2011/33-9175.pdf.*

[61] *See,* Release No. 33-9176, "Issuer Review of Assets in Offerings of Asset-Backed Securities" (January 20, 2011), *http://www.sec.gov/rules/final/2011/33-9176.pdf.*

[62] *See,* Release No. 34-65355, "Prohibition Against Conflicts of Interest in Certain Securitizations" (September 19, 2011), *http://www.sec.gov/rules/proposed/2011/34-65355.pdf.*

iting the type of conduct at which the statute is targeted without restricting legitimate securitization activities. The Commission received a number of comments on the proposal, and the staff is carefully considering those comments in preparing its recommendation to the Commission.

Corporate Governance and Executive Compensation

The Dodd-Frank Act includes a number of corporate governance and executive compensation provisions that require Commission rulemaking. Among others, such rulemakings include:

- *Say on Pay.* In accordance with Section 951 of the Act, in January 2011 the Commission adopted rules that require public companies subject to the Federal proxy rules to provide a shareholder advisory "say-on-pay" vote on executive compensation, a separate shareholder advisory vote on the frequency of the say-on-pay vote, and disclosure about, and a shareholder advisory vote to approve, compensation related to merger or similar transactions, known as "golden parachute" arrangements.[63] Companies (other than smaller reporting companies) began providing these say-on-pay and "say-on-frequency" advisory votes at shareholder meetings occurring on or after January 21, 2011. The rules provided smaller reporting companies a 2-year delayed compliance period for the say-on-pay and "frequency" votes, and those companies began complying with the rules on January 21, 2013. The Commission also proposed rules to implement the Section 951 requirement that institutional investment managers report their votes on these matters at least annually.[64]
- *Compensation Committee and Adviser Requirements.* In June 2012, the Commission adopted rules to implement Section 952 of the Act, which requires the Commission to, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer that does not comply with new compensation committee and compensation adviser requirements.[65] The new rules direct the exchanges to establish listing standards concerning compensation advisers and listing standards that require each member of a listed issuer's compensation committee to be an "independent" member of the board of directors. The rules also require disclosure about the use of compensation consultants and related conflicts of interest. Each national securities exchange must have final rules or rule amendments complying with the new rules approved by the Commission no later than June 27, 2013. To conform their rules governing independent compensation committees to the new requirements, national securities exchanges that have rules providing for the listing of equity securities have filed proposed rule changes with the Commission.[66] The Commission issued final orders approving the proposed rule changes in January 2013.[67]

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[63] *See,* Release No. 33-9178, "Shareholder Approval of Executive Compensation and Golden Parachute Compensation" (January 25, 2011), *http://www.sec.gov/rules/final/2011/33-9178.pdf.*

[64] *See,* Release No. 34-63123, "Reporting of Proxy Votes on Executive Compensation and Other Matters" (October 18, 2010), *http://www.sec.gov/rules/proposed/2010/34-63123.pdf.*

[65] *See,* Release No. 33-9330, "Listing Standards for Compensation Committees" (June 20, 2012), *http://www.sec.gov/rules/final/2012/33-9330.pdf.*

[66] *See,* Release No. 34-68022 (October 9, 2012), *http://www.sec.gov/rules/sro/bats/2012/34-68022.pdf* (BATS Exchange, Inc.); Release No. 34-68020 (October 9, 2012), *http://www.sec.gov/rules/sro/cboe/2012/34-68020.pdf* (Chicago Board of Options Exchange, Inc.); Release No. 34-68033 (October 10, 2012), *http://www.sec.gov/rules/sro/chx/2012/34-68033.pdf* (Chicago Stock Exchange, Inc.); Release No. 34-68013 (October 9, 2012), *http://www.sec.gov/rules/sro/nasdaq/2012/34-68013.pdf* (Nasdaq Stock Market LLC); Release No. 34-68018 (October 9, 2012), *http://www.sec.gov/rules/sro/bx/2012/34-68018.pdf* (Nasdaq OMX BX, Inc.); Release No. 34-68039 (October 11, 2012), *http://www.sec.gov/rules/sro/nsx/2012/34-68039.pdf* (National Stock Exchange, Inc.); Release No. 34-68011 (October 9, 2012), *http://www.sec.gov/rules/sro/nyse/2012/34-68011.pdf* (New York Stock Exchange LLC); Release No. 34-68006 (October 9, 2012), *http://www.sec.gov/rules/sro/nysearca/2012/34-68006.pdf* (NYSEArca LLC); Release No. 34-68007 (October 9, 2012), *http://www.sec.gov/rules/sro/nysemkt/2012/34-68007.pdf* (NYSE MKT LLC).

[67] *See,* Release No. 34-68643 (January 11, 2013), *http://www.sec.gov/rules/sro/bats/2013/34-68643.pdf* (BATS Exchange, Inc.); Release No. 34-68642 (January 11, 2013), *http://www.sec.gov/rules/sro/cboe/2013/34-68642.pdf* (Chicago Board of Options Exchange, Inc.); Release No. 34-68653 (January 14, 2013), *http://www.sec.gov/rules/sro/chx/2013/34-68653.pdf* (Chicago Stock Exchange, Inc.); Release No. 34-68640 (January 11, 2013), *http://www.sec.gov/rules/sro/nasdaq/2013/34-68640.pdf* (Nasdaq Stock Market LLC); Release No. 34-68641 (January 11, 2012), *http://www.sec.gov/rules/sro/bx/2013/34-68641.pdf* (Nasdaq OMX BX, Inc.); Release No. 34-68662 (January 15, 2012), *http://www.sec.gov/rules/sro/nsx/2013/34-68662.pdf* (National Stock Exchange, Inc.); Release No. 34-68635 (January 11, 2013), *http://www.sec.gov/rules/sro/nyse/2013/34-68635.pdf* (New York Stock Exchange LLC); Release No. 34-68638

- *Incentive-Based Compensation Arrangements.* Section 956 of the Dodd-Frank Act requires the Commission, along with six other financial regulators, to jointly adopt regulations or guidelines governing the incentive-based compensation arrangements of certain financial institutions, including broker-dealers and investment advisers with $1 billion or more of assets. Working with the other regulators, in March 2011 the Commission published for public comment a proposed rule that would address such arrangements.[68] The Commission has received many comment letters on the proposed rule, and the Commission staff, together with staff from the other regulators, is carefully considering the issues and concerns raised in those comments before adopting final rules.
- *Prohibition on Broker Voting of Uninstructed Shares.* Section 957 of the Act requires the rules of each national securities exchange to be amended to prohibit brokers from voting uninstructed shares in director elections (other than uncontested elections of directors of registered investment companies), executive compensation matters, or any other significant matter, as determined by the Commission by rule. The Commission has approved changes to the rules with regard to director elections and executive compensation matters for all of the national securities exchanges.[69]

The Commission also is required by the Act to adopt several additional rules related to corporate governance and executive compensation, including rules mandating new listing standards relating to specified "claw back' policies[70] and new disclosure requirements about executive compensation and company performance,[71] executive pay ratios,[72] and employee and director hedging.[73] The staff is working diligently on developing recommendations for the Commission concerning the implementation of these provisions of the Act.

Specialized Disclosure Provisions

Title XV of the Act contains specialized disclosure provisions related to conflict minerals, coal or other mine safety, and payments by resource extraction issuers to foreign or U.S. Government entities. The Commission adopted final rules for the mine safety provision in December 2011,[74] and companies are currently complying with those rules. In addition, the Commission adopted final rules for disclosure relating to conflict minerals and payments by resource extraction issuers in August

(January 11, 2013), *http://www.sec.gov/rules/sro/nysearca/2013/34-68638.pdf* (NYSEArca LLC); Release No. 34-68637 (January 11, 2013), *http://www.sec.gov/rules/sro/nysemkt/2013/34-68637.pdf* (NYSE MKT LLC).

[68] *See,* Release no. 34-64140 (March 29, 2011), *http://www.sec.gov/rules/proposed/2011/34-64140.pdf.*

[69] *See,* Release No. 34-62874 (September 9, 2010), *http://www.sec.gov/rules/sro/nyse/2010/34-62874.pdf* (New York Stock Exchange); Release No. 34-62992 (September 24, 2010), *http://www.sec.gov/rules/sro/nasdaq/2010/34-62992.pdf* (NASDAQ Stock Market LLC); Release No. 34-63139 (October 20, 2010), *http://www.sec.gov/rules/sro/ise/2010/34-63139.pdf* (International Securities Exchange); Release No. 34-63917 (February 16, 2011), *http://www.sec.gov/rules/sro/cboe/2011/34-63917.pdf* (Chicago Board Options Exchange); Release No. 34-63918 (February 16, 2011), *http://www.sec.gov/rules/sro/c2/2011/34-63918.pdf* (C2 Options Exchange, Incorporated); Release No. 34-64023 (March 3, 2011), *http://www.sec.gov/rules/sro/bx/2011/34-64023.pdf* (NASDAQ OMX BX, Inc.); Release No. 34-64024 (March 3, 2011), *http://www.sec.gov/rules/sro/bx/2011/34-64024.pdf* (Boston Options Exchange Group, LLC); Release No. 34-64121 (March 24, 2011), *http://www.sec.gov/rules/sro/chx/2011/34-64121.pdf* (Chicago Stock Exchange); Release No. 34-64122 (March 24, 2011), *http://www.sec.gov/rules/sro/phlx/2011/34-64122.pdf* (NASDAQ OMX PHLX LLC); Release No. 34-64186 (April 5, 2011), *http://www.sec.gov/rules/sro/edgx/2011/34-64186.pdf* (EDGX Exchange); Release No. 34-64187 (April 5, 2011), *http://www.sec.gov/rules/sro/edga/2011/34-64187.pdf* (EDGA Exchange); Release No. 34-65449 (September 30, 2011), *http://www.sec.gov/rules/sro/bats/2011/34-65449.pdf* (BATS Exchange, Inc.); Release No. 34-65448 (September 30, 2011), *http://www.sec.gov/rules/sro/byx/2011/34-65448.pdf* (BATS Y-Exchange, Inc.); Release No. 34-65804 (November 22, 2011), *http://www.sec.gov/rules/sro/nsx/2011/34-65804.pdf* (National Stock Exchange, Inc.); Release No. 34-66006 (December 20, 2011) *http://www.sec.gov/rules/sro/nyseamex/2011/34-66006.pdf* (NYSE Amex LLC); Release No. 34-66192 (January 19, 2012), *http://www.sec.gov/rules/sro/nysearca/2012/34-66192.pdf* (NYSE Arca, Inc.); and Release No. 68723 (January 24, 2013) (MIAX-2013-02).

[70] *See,* Section 954 of the Dodd-Frank Act.

[71] *See,* Section 953(a) of the Dodd-Frank Act.

[72] *See,* Section 953(b) of the Dodd-Frank Act.

[73] *See,* Section 955 of the Dodd-Frank Act.

[74] *See,* Release No. 33-9286, "Mine Safety Disclosure" (December 21, 2011), *http://www.sec.gov/rules/final/2011/33-9286.pdf.*

2012.[75] The conflict minerals and resource extraction issuer rulemakings were effective in November 2012 and established phase-in periods for compliance to provide issuers time to establish systems and processes to comply with the new rules. Companies subject to the conflict minerals disclosure requirement will be required to make their first filing with the disclosure on new Form SD on May 31, 2014, for the 2013 calendar year. Companies subject to the resource extraction issuer disclosure requirement will be required to comply with the rules for fiscal years ending after September 30, 2013. The conflict minerals and resource extraction issuer rulemakings are subject to pending litigation.[76]

Exempt Offerings

In December 2011, the Commission adopted rule amendments to implement Section 413(a) of the Act, which requires the Commission to exclude the value of an individual's primary residence when determining if that individual's net worth exceeds the $1 million threshold required for "accredited investor" status.[77] Section 413(a) was effective on the date of enactment of the Dodd-Frank Act and the implementing rules clarify the requirements and codify them in the Commission's rules.

Under Section 926 of the Act, the Commission is required to adopt rules that disqualify securities offerings involving certain "felons and other 'bad actors'" from relying on the safe harbor from Securities Act registration provided by Rule 506 of Regulation D. The Commission proposed rules to implement the requirements of Section 926 on May 25, 2011.[78] Under the proposal, the disqualifying events include certain criminal convictions, court injunctions and restraining orders; certain final orders of State securities, insurance, banking, savings association or credit union regulators, Federal banking agencies or the National Credit Union Administration; certain types of Commission disciplinary orders; suspension or expulsion from membership in, or from association with a member of, a securities self-regulatory organization; and certain other securities-law related sanctions. The comment period for this rule proposal has ended and the staff is developing recommendations for final rules.

Financial Stability Oversight Council

Title I of the Dodd-Frank Act provides that the Chairman of the SEC shall serve as a voting member of FSOC. FSOC provides a formal structure for coordination among the various financial regulators to monitor systemic risk and to promote financial stability across our Nation's financial system. As Chairman of the SEC, I participate in the systemic risk oversight activities of the Council and coordinate with my colleagues on the Council to facilitate efficient and effective implementation of the Dodd-Frank Act.

New Commission Offices

In addition to the Office of the Whistleblower mentioned above, the Dodd-Frank Act required the Commission to create four new offices: the Office of Credit Ratings, Office of the Investor Advocate, Office of Minority and Women Inclusion, and Office of Municipal Securities. As each of these offices is statutorily required to report directly to the Chairman, the creation of these offices was subject to approval by the Commission's Appropriations subcommittees.

Office of Credit Ratings

As required by Section 932, the Commission established an Office of Credit Ratings (OCR) with the appointment of OCR's Director in June 2012. OCR is charged with administering the rules of the Commission with respect to the practices of NRSROs in determining credit ratings for the protection of users of credit ratings

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[75] *See,* Release No. 34-67716, "Conflict Minerals" (August 22, 2012), *http://www.sec.gov/rules/final/2012/34-67716.pdf* and "Disclosure of Payments by Resource Extraction Issuers" (August 22, 2012), *http://www.sec.gov/rules/final/2012/34-67717.pdf.*

[76] *See, American Petroleum Institute, et al. v. United States Securities and Exchange Commission*, No. 12-1398 (D.C. Cir. filed Oct. 10, 2012) and *National Association of Manufacturers, et al. v. United States Securities and Exchange Commission,* No. 12-1422 (D.C. Cir. filed Oct. 19, 2012). The Commission received a motion requesting that it stay the newly adopted disclosure rules for resource extraction issuers, but the Commission declined to issue a stay order. *See, http://www.sec.gov/rules/final/2012/34-67717-motion-stay.pdf* and Release No. 68197 (November 8, 2012), *http://www.sec.gov/rules/other/2012/34-68197.pdf.* The petitioners in the litigation concerning the conflict minerals rule did not request a stay of the newly adopted rule.

[77] *See,* Release No. 33-9287, "Net Worth Standard for Accredited Investors" (December 21, 2011) and (March 23, 2012), *http://www.sec.gov/rules/final/2011/33-9287.pdf* and *http://www.sec.gov/rules/final/2012/33-9287a.pdf* (technical amendment).

[78] *See,* Release No. 33-9211, "Disqualification of Felons and Other 'Bad Actors' From Rule 506 Offerings" (May 25, 2011), *http://www.sec.gov/rules/proposed/2011/33-9211.pdf.*

and in the public interest, promoting accuracy in credit ratings issued by NRSROs and ensuring that credit ratings are not unduly influenced by conflicts of interest and that NRSROs provide greater disclosure to investors. OCR conducts examinations of NRSROs to assess and promote compliance with statutory and Commission requirements, monitors the activities of NRSROs, and provides guidance with respect to the Commission's policy and regulatory initiatives related to NRSROs.

The examination activities of OCR are focused on conducting annual, risk-based examinations of all registered NRSROs to assess compliance with Federal securities laws and Commission rules. OCR also conducts special risk-targeted examinations based on credit market issues and concerns and to follow up on tips, complaints, and NRSRO self-reported incidents. The monitoring activities of OCR are geared towards informing Commission policy and rulemaking and include identifying and analyzing risks, monitoring industry trends, and administering and monitoring the NRSRO registration process as well as the periodic updates by existing registrants of their Forms NRSRO.

The Dodd-Frank Act requires that the SEC conduct examinations of each NRSRO at least annually. OCR's scope for NRSRO examinations includes covering all eight areas required by the Dodd-Frank Act. Beginning in 2012, in an effort to be more tailored, OCR developed a risk-based approach to exam planning, identifying different risks for different NRSROs. During examinations, OCR also follows up on findings from prior exams and areas of identified risks. OCR prepares an annual public examination report as required by the Dodd-Frank Act, which summarizes the essential findings of the examinations and provides information on whether the NRSROs have appropriately addressed any previous examination recommendations. In November 2012, staff issued the second annual staff report including those findings.NRSROs have appropriately addressed any previous examination recommendations. In November 2012, staff issued the second annual staff report including those findings.NRSROs have appropriately addressed any previous examination recommendations. In November 2012, staff issued the second annual staff report including those findings. [79]

Office of the Investor Advocate

Section 915 requires the SEC to establish an Office of the Investor Advocate to assist retail investors in resolving significant problems they may have with the Commission or with SROs. The Investor Advocate also will identify areas in which investors would benefit from changes in Commission regulations or SRO rules; identify problems that investors have with financial service providers and investment products; and analyze the potential impact on investors of proposed Commission regulations and SRO rules. The Investor Advocate also must hire an Ombudsman, whose activities will be included in the Advocate's reports to Congress. The Commission is in the process of filling the position of Investor Advocate.

Office of Minority and Women Inclusion

In July 2011, shortly after the House and Senate Appropriations Committees approved the SEC's reprogramming request to create the office, the SEC formally established its Office of Minority and Women Inclusion (OMWI). The OMWI Director joined the office in January 2012.

Under a broad outreach strategy developed by OMWI, the SEC has sponsored and/or attended more than 40 career fairs, conferences, and business matchmaking events to market the SEC to diverse suppliers and job seekers. OMWI continues to partner with leading organizations focused on developing employment opportunities for minorities and women at the SEC and in the financial services industry. In addition, the OMWI Director, along with OMWI directors from other agencies, participated in joint roundtables with financial industry groups and trade organizations to foster informed dialogue regarding the development of standards for assessing the diversity policies and practices of regulated entities.

In fiscal year 2012, OMWI provided technical assistance to over 150 vendors in its efforts to expand contracting opportunities for minority-owned and women-owned businesses. While we are pleased that the percentage of contracting dollars awarded to minority-owned and women-owned businesses—as well as the percentages of minority hires for certain demographic groups, including African Americans—increased from fiscal year 2011, more needs to be done. OMWI and the Commission are committed to continuing to work proactively to encourage diversity in the work-

[79] *See,* "SEC Issues Staff Summary Report of Examinations of Nationally Recognized Statistical Rating Organizations", 2012–228 (November 2012), *http://www.sec.gov/news/studies/2012/nrsro-summary-report-2012.pdf.*

force and increase the participation of minority-owned and women-owned businesses in the SEC's programs and contracting opportunities.

Office of Municipal Securities

Section 979 of the Dodd-Frank Act required the Commission to establish an Office of Municipal Securities (OMS), reporting directly to the Chairman, to administer the rules pertaining to broker-dealers, advisors, investors and issuers of municipal securities, and to coordinate with the MSRB on rulemaking and enforcement actions. In August 2012, the Commission announced the establishment of the OMS and appointed a director. The office was previously part of the Division of Trading and Markets. One purpose behind this legislative mandate was to focus priority attention on the significant municipal securities market, which encompasses over $3.7 trillion in outstanding municipal securities, over 44,000 municipal issuers, and an average of over 12,000 bond issues annually.

The highest immediate priority project for OMS is to work together with the Division of Trading and Markets to finalize pending rules regarding registration of municipal advisors. OMS's current initiatives also include assisting with the implementation of disclosure and market structure initiatives recommended for potential further consideration by the Commission in its Report on the Municipal Securities Market, issued on July 31, 2012, following a staff review of this market sector. Briefly, these recommended initiatives include:

- a series of legislative recommendations for potential further consideration to grant the Commission direct authority to set baseline disclosure and accounting standards for municipal issuers;
- regulatory disclosure recommendations for potential further consideration to update the Commission's 1994 interpretative release concerning the disclosure obligations of issuers of municipal securities; and
- a series of market structure recommendations for potential further consideration to improve price transparency in the municipal securities market.

As noted in this Report, further action on specific recommendations will involve further study of relevant additional information, including information, as applicable, related to the costs and benefits of the recommendations and the consideration, as applicable, of public comment.

Economic Analysis

The SEC considers economic analysis to be a critical element of its rule-writing process. We are mindful that our rules have both costs and benefits, and that the steps we take to protect the investing public also impact financial markets and industry participants who must comply with our rules. In recent years, even in the face of an unprecedented rulemaking burden generated by the passage of the Act, the agency has continually enhanced its economic analysis efforts by, among other things, hiring additional Ph.D. economists and involving our economists earlier and more comprehensively in the rulemaking process. In addition, last year SEC staff received new guidance to inform the manner in which they incorporate economic analysis into their rulemaking work. [80]

Our Division of Risk, Strategy, and Financial Innovation (RSFI) directly assists in the rulemaking process by helping develop the conceptual framing for, and assisting in the subsequent writing of, the economic analysis in rule releases. Economic analysis of agency rules considers, among other things, the direct and indirect costs and benefits of the Commission's proposed regulations and reasonable alternative approaches, and the rule's effects on competition, efficiency and capital formation. Of course, analysis of the likely economic effects of proposed rules, while critical to the rulemaking process, can be challenging, and certain costs or benefits may be difficult to quantify or value with precision, particularly those that are indirect or intangible. We continue to be committed to meeting these challenges and to ensuring that the Commission engages in sound, robust analysis in its rulemaking, and we will continue to work to enhance both the process and substance of that analysis.

Section 967 Organizational Assessment

Section 967 of the Act directed the agency to engage the services of an independent consultant to study a number of specific SEC internal operations. Boston Consulting Group, Inc. (BCG) performed the assessment and provided recommended

[80] The memorandum "Current Guidance on Economic Analysis in SEC Rulemakings" is available at *http://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf.* The guidance is in effect and being followed by the rule-writing teams as they develop rule recommendations.

initiatives in March 2011.[81] The recommendations targeted various aspects of the SEC's mission, function, structure, and operations, including:

- restructuring operating divisions and support offices;
- reshaping roles and governance;
- assessing potential reprioritization of regulatory activities;
- reviewing Commission-staff interaction processes and delegations of authority;
- enhancing the SEC's operational risk management capabilities; and
- considering potential changes in the SEC's oversight of—and interaction with—self-regulatory organizations.

Since that time, the staff has undertaken an assessment of the recommendations and has provided three reports to Congress detailing the staff activities taken to implement these objectives. Thus far, recommendations and implementation plans have been completed for 15 of the 20 initiatives examined, and the implementation phase is complete or in process for each.

Funding for Implementation of the Dodd-Frank Act

Since passage of the Dodd-Frank Act,[82] the agency's existing staff has worked extraordinarily hard to conduct the large number of rulemakings, studies, and analyses required by the Act. But it has been clear to me from the outset that the Act's significant expansion of the SEC's jurisdiction over OTC derivatives, private fund advisers, municipal advisors, clearing agencies, and credit rating agencies, among others, could not be handled appropriately with the agency's previous resource levels without undermining the agency's other core duties. This is proving especially true as we turn from the first step of rule writing to efforts to support and monitor implementation and the ongoing process of examinations and enforcement of those rules. With Congress's support, the SEC received a FY2012 appropriation that permitted us to begin hiring some of the new positions needed to fulfill these responsibilities.

Despite this, I believe that the SEC does not yet have all the resources necessary to fully implement the law, and enactment of the President's Budget Request for FY2013 would be key for filling the remaining gaps. The Request was for $1.566 billion, and it would permit the agency to hire 676 additional individuals. A number of these new hires are needed to focus on enforcement, examinations, regulatory oversight, and economic and data analysis related to the Act.

In FY2013, the SEC also is aiming to continue investing in its technology capabilities to implement the law and police the markets. In particular, we hope to strengthen our ability to take in, organize, and analyze data on the new markets and entities under the agency's jurisdiction. The enactment of the President's Budget Request, as well as the continued use of the agency's Reserve Fund, will be essential to that effort.

If the SEC does not receive additional resources, I believe that many of the issues to which the Dodd-Frank Act is directed will not be adequately addressed. The SEC would be unable to sufficiently build out its technology and hire the industry experts and other staff sorely needed to oversee and police these new areas of responsibility.

It is important to keep in mind that, under the Dodd-Frank Act, the SEC collects transaction fees that offset the annual appropriation to the SEC. Accordingly, regardless of the amount appropriated to the SEC, I believe that it is appropriate to note that the appropriation will be fully offset by the fees that we collect, and therefore will have no impact on the Nation's budget deficit.

Conclusion

The Dodd-Frank Act has required the SEC to undertake the largest and most complex rulemaking agenda in the history of the agency. To date, a tremendous amount of progress has been made to implement that agenda, including significant effort intended to increase transparency, mitigate risk, protect against market abuse in security-based swaps markets, improve the oversight of credit rating agencies and hedge fund and other private fund advisers, and develop a better understanding of the systemic risk presented by large private funds. As the Commission strives to complete the additional work that remains, we look forward to working with this

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[81] The BCG Report is available at *http://www.sec.gov/news/studies/2011/967study.pdf.*

[82] In accordance with past practice, the FY2013 budget justification of the agency was submitted by the Chairman of the Commission and was not voted on by the full Commission. Therefore, this section of the testimony does not necessarily represent the views of all SEC Commissioners.

Committee and other stakeholders in the financial marketplace to adopt rules that protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. Thank you for inviting us to share with you our progress to date and our plans going forward. I look forward to answering your questions.

PREPARED STATEMENT OF GARY GENSLER

CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

FEBRUARY 14, 2013

Good morning Chairman Johnson, Ranking Member Crapo, and Members of the Committee. I thank you for inviting me to today's hearing on implementation of Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) swaps market reforms. I am pleased to testify along with my fellow regulators. I also want to thank the CFTC Commissioners and staff for their hard work and dedication.

The New Era of Swaps Market Reform

This hearing is occurring at an historic time in the markets. The CFTC now oversees the derivatives marketplace—across both futures and swaps. The marketplace is increasingly shifting to implementation of the commonsense rules of the road for the swaps market that Congress included in the Dodd-Frank Act.

For the first time, the public is benefiting from seeing the price and volume of each swap transaction. This post-trade transparency builds upon what has worked for decades in the futures and securities markets. The new swaps market information is available free of charge on a Web site, like a modern-day ticker tape.

For the first time, the public will benefit from the greater access to the markets and the risk reduction that comes with central clearing. Required clearing of interest rate and credit index swaps between financial entities begins next month.

For the first time, the public will benefit from specific oversight of swap dealers. As of today, 71 swap dealers are provisionally registered. They are subject to standards for sales practices, record keeping and business conduct to help lower risk to the economy and protect the public from fraud and manipulation. The full list of registered swap dealers is on the CFTC's Web site, and we will update it as more entities register.

An earlier economic crisis led President Roosevelt and Congress to enact similar commonsense rules of the road for the futures and securities markets. I believe these critical reforms of the 1930s have been at the foundation of our strong capital markets and many decades of economic growth.

In the 1980s, the swaps market emerged. Until now, though, it had lacked the benefit of rules to promote transparency, lower risk and protect the public, rules that we have come to depend upon in the securities and futures markets. What followed was the 2008 financial crisis. Eight million American jobs were lost. In contrast, the futures market, supported by earlier reforms, weathered the financial crisis.

Congress and President Obama responded to the worst economic crisis since the Great Depression and carefully crafted the Dodd-Frank swaps provisions. They borrowed from what has worked best in the futures market for decades: transparency, clearing, and oversight of intermediaries.

The CFTC has largely completed swaps market rule writing, with 80 percent behind us. On October 12, the CFTC and Securities and Exchange Commission's (SEC) foundational definition rules went into effect. This marked the new era of swaps market reform.

The CFTC is seeking to consider and finalize the remaining Dodd-Frank swaps reforms this year. In addition, as Congress directed the CFTC to do, I believe it's critical that we continue our efforts to put in place aggregate speculative position limits across futures and swaps on physical commodities.

The agency has completed each of our reforms with an eye toward ensuring that the swaps market works for end users, America's primary job providers. It's the end users in the nonfinancial side of our economy that provide 94 percent of private sector jobs.

The CFTC's swaps market reforms benefit end users by lowering costs and increasing access to the markets. They benefit end users through greater transparency—shifting information from Wall Street to Main Street. Following Congress' direction, end users are not required to bring swaps into central clearing. Further, the Commission's proposed rule on margin provides that end users will not have to post margin for uncleared swaps. Also, nonfinancial companies, other than those genuinely making markets in swaps, will not be required to register as swap dealers. Lastly, when end users are required to report their transactions, they are given more time to do so than other market participants.

Congress also authorized the CFTC to provide relief from the Dodd-Frank Act's swaps reforms for certain electricity and electricity-related energy transactions between rural electric cooperatives and Federal, State, municipal and tribal power authorities. Similarly, Congress authorized the CFTC to provide relief for certain transactions on markets administered by regional transmission organizations and independent system operators. The CFTC is looking to soon finalize two exemptive orders related to these various transactions, as Congress authorized.

The CFTC has worked to complete the Dodd-Frank reforms in a deliberative way—not against a clock. We have been careful to consider significant public input, as well as the costs and benefits of each rule. CFTC Commissioners and staff have met more than 2,000 times with members of the public, and we have held 22 public roundtables. The agency has received more than 39,000 comment letters on matters related to reform. Our rules also have benefited from close consultation with domestic and international regulators and policy makers.

Throughout this process, the Commission has sought input from market participants on appropriate schedules to phase in compliance with swaps reforms. Now, over 2½ years since Dodd-Frank passed and with 80 percent of our rules finalized, the market is moving to implementation. Thus, it's the natural order of things that market participants have questions and have come to us for further guidance. The CFTC welcomes inquiries from market participants, as some fine-tuning is expected. As it is sometimes the case with human nature, the agency receives many inquiries as compliance deadlines approach.

My fellow commissioners and I, along with CFTC staff, have listened to market participants and thoughtfully sorted through issues as they were brought to our attention, as we will continue to do.

I now will go into further detail on the Commission's swaps market reform efforts.

Transparency—Lowering Cost and Increasing Liquidity, Efficiency, Competition

Transparency—a longstanding hallmark of the futures market—both pre- and post-trade—lowers costs for investors, consumers and businesses. It increases liquidity, efficiency and competition. A key benefit of swaps reform is providing this critical pricing information to businesses and other end users across this land that use the swaps market to lock in a price or hedge a risk.

As of December 31, 2012, provisionally registered swap dealers are reporting in real time their interest rate and credit index swap transactions to the public and to regulators through swap data repositories. These are some of the same products that were at the center of the financial crisis. Building on this, swap dealers will begin reporting swap transactions in equity, foreign exchange and other commodity asset classes on February 28. Other market participants will begin reporting April 10.

With these transparency reforms, the public and regulators now have their first full window into the swaps marketplace.

Time delays for reporting currently range from 30 minutes to longer, but will generally be reduced to 15 minutes this October for interest rate and credit index swaps. For other asset classes, the time delay will be reduced next January. After the CFTC completes the block rule for swaps, trades smaller than a block will be reported as soon as technologically practicable.

To further enhance liquidity and price competition, the CFTC is working to finish the pretrade transparency rules for swap execution facilities (SEFs), as well as the block rule for swaps. SEFs would allow market participants to view the prices of available bids and offers prior to making their decision on a transaction. These rules will build on the democratization of the swaps market that comes with the clearing of standardized swaps.

Clearing—Lowering Risk and Democratizing the Market

Since the late 19th century, clearinghouses have lowered risk for the public and fostered competition in the futures market. Clearing also has democratized the market by fostering access for farmers, ranchers, merchants, and other participants.

A key milestone was reached in November 2012 with the CFTC's adoption of the first clearing requirement determinations. The vast majority of interest rate and credit default index swaps will be brought into central clearing. This follows through on the U.S. commitment at the 2009 G20 meeting that standardized swaps should be brought into central clearing by the end of 2012. Compliance will be phased in throughout this year. Swap dealers and the largest hedge funds will be required to clear March 11, and all other financial entities follow June 10. Accounts managed by third party investment managers and ERISA pension plans have until September 9 to begin clearing.

Consistent with the direction of Dodd-Frank, the Commission in the fall of 2011 adopted a comprehensive set of rules for the risk management of clearinghouses. These final rules were consistent with international standards, as evidenced by the Principles for Financial Market Infrastructures (PFMIs) consultative document that had been published by the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions (CPSS–IOSCO).

In April of 2012, CPSS–IOSCO issued the final PFMIs. The Commission's clearinghouse risk management rules cover the vast majority of the standards set forth in the final PFMIs. There are a small number of areas where it may be appropriate to augment our rules to meet those standards, particularly as it relates to systemically important clearinghouses. I have directed staff to work expeditiously to recommend the necessary steps so that the Commission may implement any remaining items from the PFMIs not yet incorporated in our clearinghouse rules. I look forward to the Commission considering action on this in 2013.

I expect that soon we will complete a rule to exempt swaps between certain affiliated entities within a corporate group from the clearing requirement. This year, the CFTC also will be considering possible clearing determinations for other commodity swaps, including energy swaps.

Swap Dealer Oversight—Promoting Market Integrity and Lowering Risk

Comprehensive oversight of swap dealers, a foundational piece of Dodd-Frank, will promote market integrity and lower risk to taxpayers and the rest of the economy. Congress wanted end users to continue benefiting from customized swaps (those not brought into central clearing) while being protected through the express oversight of swap dealers. In addition, Dodd-Frank extended the CFTC's existing oversight of previously regulated intermediaries to include their swaps activity. Such intermediaries have historically included futures commission merchants, introducing brokers, commodity pool operators, and commodity trading advisors.

As the result of CFTC rules completed in the first half of last year, 71 swap dealers are now provisionally registered. This initial group of dealers includes the largest domestic and international financial institutions dealing in swaps with U.S. persons. It includes the 16 institutions commonly referred to as the G16 dealers. Other entities are expected to register over the course of this year once they exceed the de minimis threshold for swap dealing activity.

In addition to reporting trades to both regulators and the public, swap dealers will implement crucial back office standards that lower risk and increase market integrity. These include promoting the timely confirmation of trades and documentation of the trading relationship. Swap dealers also will be required to implement sales practice standards that prohibit fraud, treat customers fairly and improve transparency. These reforms are being phased in over the course of this year.

The CFTC is collaborating closely domestically and internationally on a global approach to margin requirements for uncleared swaps. We are working along with the Federal Reserve, the other U.S. banking regulators, the SEC and our international counterparts on a final set of standards to be published by the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO). The CFTC's proposed margin rules excluded nonfinancial end users from margin requirements for uncleared swaps. We have been advocating with global regulators for an approach consistent with that of the CFTC. I would anticipate that the CFTC, in consultation with European regulators, would take up a final margin rules, as well as related rules on capital, in the second half of this year.

Following Congress' mandate, the CFTC also is working with our fellow domestic financial regulators to complete the Volcker Rule. In adopting the Volcker Rule, Congress prohibited banking entities from proprietary trading, an activity that may put taxpayers at risk. At the same time, Congress permitted banking entities to engage in certain activities, such as market making and risk mitigating hedging. One of the challenges in finalizing a rule is achieving these multiple objectives.

International Coordination on Swaps Market Reform

In enacting financial reform, Congress recognized the basic lessons of modern finance and the 2008 crisis. During a default or crisis, risk knows no geographic border. Risk from our housing and financial crisis contributed to economic downturns around the globe. Further, if a run starts on one part of a modern financial institution, almost regardless of where it is around the globe, it invariably means a funding and liquidity crisis rapidly spreads and infects the entire consolidated financial entity.

This phenomenon was true with the overseas affiliates and operations of AIG, Lehman Brothers, Citigroup, and Bear Stearns.

AIG Financial Products, for instance, was a Connecticut subsidiary of New York insurance giant that used a French bank license to basically run its swaps operations out of Mayfair in London. Its collapse nearly brought down the U.S. economy.

Last year's events of JPMorgan Chase, where it executed swaps through its London branch, are a stark reminder of this reality of modern finance. Though many of these transactions were entered into by an offshore office, the bank here in the United States absorbed the losses. Yet again, this was a reminder that in modern finance, trades booked offshore by U.S. financial institutions should not be confused with keeping that risk offshore.

Failing to incorporate these basic lessons of modern finance into the CFTC's oversight of the swaps market would fall short of the goals of Dodd-Frank reform. It would leave the public at risk.

More specifically, I believe that Dodd-Frank reform applies to transactions entered into by overseas branches of U.S. entities with non-U.S. persons, as well as between overseas affiliates guaranteed by U.S. entities. Failing to do so would mean American jobs and markets may move offshore, but, particularly in times of crisis, risk would come crashing back to our economy.

Similar lessons of modern finance were evident, as well, with the collapse of the hedge fund Long-Term Capital Management in 1998. It was run out of Connecticut, but its $1.2 trillion swaps were booked in its Cayman Islands affiliate. The risk from those activities, as the events of the time highlighted, had a direct and significant effect here in the United States.

The same was true when Bear Stearns in 2007 bailed out two of its sinking hedge fund affiliates, which had significant investments in subprime mortgages. They both were organized offshore. This was just the beginning of the end, as within months, the Federal Reserve provided extraordinary support for the failing Bear Stearns.

We must thus ensure that collective investment vehicles, including hedge funds, that either have their principle place of business in the United States or are directly or indirectly majority owned by U.S. persons are not able to avoid the clearing requirement—or any other Dodd-Frank requirement—simply due to how they might be organized.

We are hearing, though, that some swap dealers may be promoting to hedge funds an idea to avoid required clearing, at least during an interim period from March until July. I would be concerned if, in an effort to avoid clearing, swap dealers route to their foreign affiliates trades with hedge funds organized offshore, even though such hedge funds' principle place of business was in the United States or they are majority owned by U.S. persons. The CFTC is working to ensure that this idea does not prevail and develop into a practice that leaves the American public at risk. If we don't address this, the P.O. boxes may be offshore, but the risk will flow back here.

Congress understood these issues and addressed this reality of modern finance in Section 722(d) of the Dodd-Frank Act, which states that swaps reforms shall not apply to activities outside the United States unless those activities have "a direct and significant connection with activities in, or effect on, commerce of the United States." Congress provided this provision solely for swaps under the CFTC's oversight and provided a different standard for securities-based swaps under the SEC's oversight.

To give financial institutions and market participants guidance on 722(d), the CFTC last June sought public consultation on its interpretation of this provision. The proposed guidance is a balanced, measured approach, consistent with the cross-border provisions in Dodd-Frank and Congress' recognition that risk easily crosses borders.

Pursuant to Commission guidance, foreign firms that do more than a de minimis amount of swap-dealing activity with U.S. persons would be required to register with the CFTC within about 2 months after crossing the de minimis threshold. A number of international financial institutions are among the 71 swap dealers that are provisionally registered with the CFTC.

Where appropriate, we are committed to permitting, foreign firms and, in certain circumstances, overseas branches and guaranteed affiliates of U.S. swap dealers, to comply with Dodd-Frank through complying with comparable and comprehensive foreign regulatory requirements. We call this substituted compliance.

For foreign swap dealers, we would allow such substituted compliance for requirements that apply across a swap dealer's entity, as well as for certain transaction-level requirements when facing overseas branches of U.S. entities and overseas affiliates guaranteed by U.S. entities. Entity-level requirements include capital, chief compliance officer and swap data record keeping. Transaction-level requirements include clearing, margin, real-time public reporting, trade execution, trading documentation and sales practices.

When foreign swaps dealers transact with a U.S. person, though, compliance with Dodd-Frank is required.

To assist foreign swap dealers with Dodd-Frank compliance, the CFTC recently finalized an exemptive order that applies until mid-July 2013. This Final Order for foreign swap dealers incorporates many suggestions from the ongoing consultation on cross-border issues with foreign regulatory counterparts and market participants. For instance, the definition of "U.S. person" in the Order benefited from the comments in response to the July 2012 proposal.

Under this Final Order, foreign swap dealers may phase in compliance with certain entity-level requirements. In addition, the Order provides time-limited relief for foreign dealers from specified transaction-level requirements when they transact with overseas affiliates guaranteed by U.S. entities, as well as with foreign branches of U.S. swap dealers.

The Final Order provides time for the Commission to continue working with foreign regulators as they implement comparable swaps reforms and as the Commission considers substituted compliance determinations for the various foreign jurisdictions with entities that have registered as swap dealers under Dodd-Frank.

The CFTC will continue engaging with our international counterparts through bilateral and multilateral discussions on reform and cross-border swaps activity. Just last week, SEC Chairman Walter and I had a productive meeting with international market regulators in Brussels.

Given our different cultures, political systems and legislative mandates some differences are unavoidable, but we've made great progress internationally on an aligned approach to reform. The CFTC is committed to working through any instances where we are made aware of a conflict between U.S. law and that of another jurisdiction.

Customer Protection

Dodd-Frank included provisions directing the CFTC to enhance the protection of swaps customer funds. While it was not a requirement of Dodd-Frank, in 2009 the CFTC also reviewed our existing customer protection rules for futures market customers. As a result, a number of our customer protection enhancements affect both futures and swaps market customers. I would like to review our finalized enhancements, as well as an important customer protection proposal.

The CFTC's completed amendments to rule 1.25 regarding the investment of customer funds benefit both futures and swaps customers. The amendments include preventing in-house lending of customer money through repurchase agreements. The CFTC's gross margining rules for futures and swaps customers require clearinghouses to collect margin on a gross basis. Futures commission merchants (FCMs) are no longer able to offset one customer's collateral against another or to send only the net to the clearinghouse.

Swaps customers further benefit from the new so-called LSOC (legal segregation with operational comingling) rules, which ensure their money is protected individually all the way to the clearinghouse.

The Commission also worked closely with market participants on new rules for customer protection adopted by the self-regulatory organization (SRO), the National Futures Association. These include requiring FCMs to hold sufficient funds for U.S. foreign futures and options customers trading on foreign contract markets (in Part 30 secured accounts). Starting last year, they must meet their total obligations to customers trading on foreign markets computed under the net liquidating equity method. In addition, FCMs must maintain written policies and procedures governing the maintenance of excess funds in customer segregated and Part 30 secured accounts. Withdrawals of 25 percent or more would necessitate preapproval in writing by senior management and must be reported to the designated SRO and the CFTC.

These steps were significant, but market events have further highlighted that the Commission must do everything within our authorities and resources to strengthen oversight programs and the protection of customers and their funds.

In the fall of 2012, the Commission sought public comment on a proposal to further enhance the protection of customer funds.

The proposal, which the CFTC looks forward to finalizing this year, would strengthen the controls around customer funds at FCMs. It would set new regulatory accounting requirements and would raise minimum standards for independent public accountants who audit FCMs. And it would provide regulators with daily direct electronic access to the FCMs' bank and custodial accounts for customer funds. Last week, the CFTC held a public roundtable on this proposal, the third roundtable focused on customer protection.

Further, the CFTC intends to finalize a rule this year on segregation for uncleared swaps.

Benchmark Interest Rates

I'd like to now turn to the three cases the CFTC brought against Barclays, UBS, and RBS for manipulative conduct with respect to the London Interbank Offered Rate (LIBOR) and other benchmark interest rate submissions. The reason it's important to focus on these matters is not because there were $2.5 billion in fines, though the U.S. penalties against these three banks of more than $2 billion were significant. What this is about is the integrity of the financial markets. When a reference rate, such as LIBOR—central to borrowing, lending and hedging in our economy—has been so readily and pervasively rigged, it's critical that we discuss how to best change the system. We must ensure that reference rates are honest and reliable reflections of observable transactions in real markets.

The three cases shared a number of common traits. Foremost, at each institution the misconduct spanned multiple years, involved offices in multiple cities around the globe, included numerous people, and affected multiple benchmark rates and currencies. In each case, there was evidence of collusion among banks. In both the UBS and RBS cases, one or more interdealer brokers were asked to paint false pictures to influence submissions of other banks, i.e., to spread the falsehoods more widely. At Barclays and UBS, the banks also were reporting falsely low borrowing rates in an effort to protect their reputation.

Why does this matter?

The derivatives marketplace that the CFTC oversees started about 150 years ago. Futures contracts initially were linked to physical commodities, like corn and wheat. Such clear linkage ultimately comes from the ability of farmers, ranchers and other market participants to physically deliver the commodity at the expiration of the contract. As the markets evolved, cash-settled contracts emerged, often linked to markets for financial commodities, like the stock market or interest rates. These cash-settled derivatives generally reference indices or benchmarks.

Whether linked to physical commodities or indices, derivatives—both futures and swaps—should ultimately be anchored to observable prices established in real underlying cash markets. And it's only when there are real transactions entered into at arm's length between buyers and sellers that we can be confident that prices are discovered and set accurately.

When market participants submit for a benchmark rate that lacks observable underlying transactions, even if operating in good faith, they may stray from what real transactions would reflect. When a benchmark is separated from real transactions, it is more vulnerable to misconduct.

Today, LIBOR is the reference rate for 70 percent of the U.S. futures market, most of the swaps market and nearly half of U.S. adjustable rate mortgages. It's embedded in the wiring of our financial system.

The challenge we face is that the market for interbank, unsecured borrowing has largely diminished over the last 5 years. Some say that it is essentially nonexistent. In 2008, Mervyn King, the governor of the Bank of England, said of Libor: "It is, in many ways, the rate at which banks do not lend to each other."

The number of banks willing to lend to one another on such terms has been sharply reduced because of economic turmoil, including the 2008 global financial crisis, the European debt crisis that began in 2010, and the downgrading of large banks' credit ratings. In addition, there have been other factors that have led to unsecured, interbank lending drying up, including changes to Basel capital rules and central banks providing funding directly to banks.

Fortunately, much work is occurring internationally to address these issues. I want to commend the work of Martin Wheatley and the U.K. Financial Services Authority (FSA) on the "Wheatley Review of LIBOR". Additionally, the CFTC and the FSA are cochairing the International Organization of Securities Commissions (IOSCO) Task Force that is developing international principles for benchmarks and examining best mechanisms or protocols for transition, if needed. On January 11, the IOSCO Task Force published the *Consultation Report on Financial Benchmarks.*

The consultation report said: "The Task Force is of the view that a benchmark should as a matter of priority be anchored by observable transactions entered into at arm's length between buyers and sellers in order for it to function as a credible indicator of prices, rates or index values." It went on to say: "However, at some point, an insufficient level of actual transaction data raises concerns as to whether the benchmark continues to reflect prices or rates that have been formed by the competitive forces of supply and demand."

Among the questions for the public in the report are the following:

- What are the best practices to ensure that benchmark rates honestly reflect market prices?
- What are best practices for benchmark administrators and submitters?
- What factors should be considered in determining whether a current benchmark's underlying market is sufficiently robust? For instance, what is an insufficient level of actual transaction activity?
- And what are the best mechanisms or protocols to transition from an unreliable or obsolete benchmark?

On February 20, we are holding a public roundtable in London. On February 26, the CFTC is hosting a second roundtable to gather input from market participants and other interested parties. A final report incorporating this crucial public input will be published this spring.

Resources

The CFTC's hardworking team of 690 is less than 10 percent more in numbers than at our peak in the 1990s. Yet since that time, the futures market has grown five-fold, and the swaps market is eight times larger than the futures market. Market implementation of swaps reforms means additional resources for the CFTC are all the more essential. Investments in both technology and people are needed for effective oversight of these markets by regulators—like having more cops on the beat.

Though data has started to be reported to the public and to regulators, we need the staff and technology to access, review and analyze the data. Though 71 entities have registered as new swap dealers, we need people to answer their questions and work with the NFA on the necessary oversight to ensure market integrity. Furthermore, as market participants expand their technological sophistication, CFTC technology upgrades are critical for market surveillance and to enhance customer fund protection programs.

Without sufficient funding for the CFTC, the Nation cannot be assured this agency can closely monitor for the protection of customer funds and utilize our enforcement arm to its fullest potential to go after bad actors in the futures and swaps markets. Without sufficient funding for the CFTC, the Nation cannot be assured that this agency can effectively enforce essential rules that promote transparency and lower risk to the economy.

The CFTC is currently funded at $207 million. To fulfill our mission for the benefit of the public, the President requested $308 million for fiscal year 2013 and 1,015 full-time employees.

Thank you again for inviting me today, and I look forward to your questions.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM MARY J. MILLER

Q.1. Given how complex it is to determine whether a trade is a hedge or a proprietary trade, it appears the real issue is whether a trade threatens the safety and soundness of the bank. What benchmark does your agency use to determine whether a particular activity is or is not "hedging"? How does your agency determine whether the trade presents risks to the safety and soundness of a financial institution?

A.1. Although Treasury is responsible for coordination of the regulations issued by the rulewriting agencies to implement the Volcker Rule, Treasury is not itself a rulewriting agency. The purpose of the Volcker Rule is to prohibit banking entities that have access to the Federal safety net from engaging in risky proprietary trading or making certain investments in private equity or hedge funds, while preserving important activities such as market making and hedging. As the Council noted in its Volcker Rule study in January 2011, and as the SEC, the CFTC, and the Federal banking agencies noted in their proposed rules to implement the Volcker Rule, the challenge inherent in creating a robust implementation framework is that certain classes of permitted activities—in particular, market making, hedging, underwriting, and other transactions on behalf of customers—often evidence outwardly similar characteristics to prohibited proprietary trading, even as they pursue different objectives. Additionally, effective implementation of the Volcker Rule requires careful attention to differences between types of financial markets and asset classes.

Since the closing of the public comment period, the regulators have been working to address these and other issues raised in the thousands of comments submitted on the proposal.

Q.2. In its November 2011 report, GAO recommended that FSOC work with the Federal financial regulators to establish formal coordination policies for Dodd-Frank rulemakings, such as when coordination should occur. Nonetheless, the FSOC has not established such formal policies to date. In its September 2012 report, GAO noted that a number of industry representatives questioned why FSOC could not play a greater role in coordinating member agencies' rulemaking efforts since the FSOC chairperson is responsible for regular consultation with regulators and other appropriate organizations of foreign Governments or international organizations. Does Treasury agree with GAO's recommendation? If so, when will FSOC issue formal interagency coordination policies? Is there a reason why FSOC could not play a greater role in coordinating member agencies' rulemaking efforts?

A.2. The Council appreciates the work of the GAO and the important oversight function that it provides. To that end, the Council has reviewed all recommendations made by the GAO regarding ways in which the Council might further enhance collaboration and coordination and has provided responses on actions planned and taken. As noted in its responses, the Council developed written protocols for the statutorily required consultations that are part of certain rulemakings required by the Dodd-Frank Act. Additionally, one of the Council's first activities was to establish an open operational framework that included the creation of standing committees composed of staff of Council members and member agencies. The interagency participation in these committees draws upon the collective policy and supervisory expertise of all of the Council members and institutionalizes opportunities for discussion, collaboration, and coordination. These teams have collaborated on the publication of three annual reports and six additional studies or reports related to important issues such as the Volcker Rule, the concentration limit on large financial companies, and contingent capital, and performed work enabling the Council to designate eight financial market utilities as systemically important. Interagency teams continue to support the Council on its evaluation of nonbank financial companies for potential designation, proposed recommendations for money market mutual fund reform, and coordination with the Federal Reserve Board on enhanced prudential standards.

Congress did not provide the Council or its Chairperson with the authority to require coordination in all cases among its independent member agencies. However, the Council, the Deputies Committee, and Council staff are committed to identifying ways to enhance collaboration as work is conducted through the Council's committees and working groups.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SCHUMER FROM MARY J. MILLER

Q.1. In September 2012, the Government Accountability Office (GAO) issued a report on the Financial Stability Oversight Council (FSOC) and the Office of Financial Research (OFR),[1] in which it found that the FSOC has not fully leveraged outside expertise or used its authority to convene advisory committees comprised of industry representatives, academics, and State regulators to help inform its work. What has FSOC and/or OFR done since the report to address this finding? Should there be more formal structures and processes to ensure that the voices of key stakeholders and experts are heard?

A.1. Since the GAO issued its report, the Council and the OFR have further leveraged outside expertise in several ways. Most notably, in November 2012, Treasury announced the members of a new Financial Research Advisory Committee, which will work with the OFR to recommend ways to develop and employ best practices for data management, data standards, and research methodologies. The committee is made up of 30 distinguished professionals in economics, finance, financial services, data management, risk management, and information technology. Members include two Nobel laureates in economics, leaders in business and nonprofit fields, and prominent researchers at major universities and think tanks. The committee held its inaugural meeting in December 2012 in Washington, DC, and has been active through subcommittees that are focused on research, data, technology, risk management, and other issues. In addition, through the OFR's ongoing work and symposia,

[1] GAO-12-886 (Report to Congressional Requesters "FINANCIAL STABILITY New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions" (September 2012)).

the Council is able to draw on the insights and expertise of various industry experts and academics on cutting edge systemic risk and financial stability analyses and methods. The OFR's work to establish the Legal Entity Identifier has also involved extensive collaboration with global regulatory authorities, standards setting bodies, and industry professionals.

Additionally, the Council and its committees are committed to continuing to facilitate information sharing among its members and other parties through the Council's existing collaboration and consultation practices. With respect to seeking input from State regulators in particular, State banking, State insurance, and State securities regulators are Council members and participate actively in the discussions of the Council and its committees. The Council has also demonstrated its commitment to public input by actively seeking public comment on a number of matters, including its rule and guidance regarding the designation of nonbank financial companies, and its proposed recommendations regarding money market mutual fund reform.

Q.2. While I understand the sensitivity of many of the issues within the FSOC's purview, the GAO report nevertheless raised serious concerns about the FSOC's and OFR's full commitment to transparency, a shortcoming that could undermine the ability of FSOC and OFR to carry out their Congressionally mandated mission. GAO observed that "limits to FSOC's and OFR's transparency also contribute to questions about their effectiveness."[2] What specific steps will you take to increase transparency at FSOC and OFR going forward?

A.2. The Council and the OFR have taken a number of steps in recent months to further demonstrate their commitment to transparency and accountability. Since the publication of the GAO report, the OFR and the Council completed redesigns of their Web sites to improve transparency and usability, to improve access to Council documents and reports, and to allow users to receive updates when new content is added. These include the annual reports of the Council and the OFR, working papers, Congressional testimony, Congressional briefings and meetings, the OFR's Annual Report to Congress on Human Capital Planning, and information about the Financial Research Advisory Committee, the Legal Entity Identifier Initiative, and assessments. Both redesigned Web sites were available to the public by December 2012, with continued enhancements expected over time. In addition, as noted above, in November 2012 Treasury announced the members of a new Financial Research Advisory Committee, which will work with the OFR to recommend ways to develop and employ best practices for data management, data standards, and research methodologies. This committee has already held one public meeting and will hold more. The OFR also sponsored its second Web cast conference this year. Representatives of both the Council and the OFR have also testified publicly before Congress and responded to numerous requests for information from various oversight bodies. Further, the OFR has built on its strategic planning and performance management

[2] Id., p. 54.

system by finalizing and beginning to track foundational performance measures for each of its strategic goals.

The Council is firmly committed to holding open meetings, and closes meetings only when appropriate. The Council's transparency policy commits the Council to hold two open meetings each year, and the Council has held ten open meetings in its first 2½ years. However, the Council must continue to balance its responsibility to be transparent with its central mission to monitor emerging threats to financial stability. This frequently requires discussion of supervisory and other market-sensitive data during Council meetings, including information about individual firms, transactions, and markets that may only be obtained if maintained on a confidential basis. Continued protection of this information is necessary to prevent destabilizing market speculation that could occur if that information were to be disclosed. However, in light of the GAO's recommendation, the Council's Deputies Committee will consider whether to recommend any further changes to the Council's transparency policy.

Q.3. The FSOC stated, in April 2012, that it had requested that the OFR conduct a study of the asset management industry, to determine (i) what risks, if any, this industry poses to the U.S. financial system, and (ii) whether any such risks were best addressed through designation or some other means. The results of the study would presumably inform the FSOC whether to consider asset managers as potentially subject to designation as nonbank SIFIs. What process have the FSOC and OFR established to solicit and consider input from the public, including industry, regulators (FSOC members and non-FSOC members), academics, and other interested parties?

Will the results of the analysis be made public and will interested parties be provided the opportunity to comment formally on the results?

Will the FSOC provide the public with an opportunity to comment on any metrics and thresholds relating to the potential designation of asset management companies as nonbank systemically important financial institutions prior to the designation of any such company?

A.3. The Council is reviewing generally the activities of asset management companies and their impact on the U.S. financial system. The Council has asked the OFR to supply data and analysis to inform the Council's review. As part of this analysis, the Council and OFR staff have met with market participants, including asset managers, to learn more about the relevant activities and business models.

The Council's work is ongoing. Were the Council to determine that it would be appropriate to develop additional metrics that would be used to identify asset management firms for further evaluation for potential designation, I expect that it would provide the public with an opportunity to review and comment on any such metrics, in accordance with past practice. As demonstrated by the Council's multiple requests for comment on its proposed rule and interpretive guidance regarding nonbank financial company designations, the Council values the input of all interested parties, stakeholders, and the public.

Consistent with the Dodd-Frank Act, however, the Council does not intend to delay consideration of any nonbank financial company for potential designation, if the Council believes that material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the company, could pose a threat to the financial stability of the United States.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNER FROM MARY J. MILLER

Q.1. The statutory language for funds defined under the Volcker Rule pointedly did not include venture funds, however the definition in the proposed rule seemed to indicate that venture funds would be covered. In addition to exceeding the statutory intent of Congress, this has created uncertainty in the market as firms await a final rule and refrain from making commitments which might be swept up in the final version of the Volcker Rule. Can you clarify whether venture funds are covered by the Volcker Rule?

A.1. Congress defined private equity and hedge funds for purposes of the Volcker Rule as those entities that rely on the exemptions under section 3(c)(1) or 3(c)(7) of the Investment Company Act, rather than creating a separate classification or treatment of venture capital funds. The Council recognized the potential overbreadth of this issue in its study and recommended that the rulemaking agencies consider whether certain entities should be exempted, including venture capital funds.

The comment letters submitted in response to the proposed rules reflect sharply diverging views on whether venture capital funds should be exempted. As with the other issues raised in the comment letters, we expect the rulemaking agencies will consider these comments carefully and take them into consideration in developing the final rules.

Q.2. You have previously commented on the progress we have made on improving capital and the evolving market perception of too big to fail. Do you see any changes in the behavior of investors in distinguishing among large institutions and variance in their borrowing costs and credit default spreads?

A.2. If investors still perceived large banks as "too big to fail," we would expect to see persistently low credit spreads for such firms with little variation between firms, as we did in the years leading up to the financial crisis. But in the aftermath of the crisis, investors are both assigning a greater likelihood of loss from default and also distinguishing between financial institutions, as measured by higher overall levels of, and a wider variance between credit default swap (CDS) spreads that markets use to assess credit risk.

Also, we would expect the largest banks' borrowing costs to be low and vary little by the size of the institution or its activities, as was the case before the crisis. Today, while borrowing costs generally remain low for all banks as a result of historically low interest rates, long-term debt spreads have increased significantly more for the largest, most complex banks than their smaller competitors.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM MARY J. MILLER

Q.1. The latest report from the Special Inspector General for TARP revealed that AIG, GM, and Ally recently requested pay raises for 18 top executives. Fourteen of those 18 raises were for more than $100,000 and the highest amount was about $1 million. Treasury approved 18 out of 18 requests.

Can you explain what Treasury looked for in evaluating these salary increases?

What sorts of factors would cause Treasury to reject a salary increase?

What are Treasury's views on SIGTARP's ongoing recommendation to put in place more effective policies and procedures for evaluating compensation at these institutions?

A.1. The Interim Final Rule on TARP Standards for Compensation and Corporate Governance makes clear that Treasury's Office of the Special Master (OSM) must balance limiting compensation and making sure that pay is at levels that will permit the exceptional assistance recipients to compete—including maintaining the ability to attract and retain employees—so they can exit TARP and repay taxpayers. The process that OSM created in 2009, and that it continues to follow today, accomplishes this objective by requesting comprehensive submissions from the exceptional assistance companies, which it then thoroughly and carefully examines. In reviewing these submissions, OSM analyzes market data to determine what constitutes competitive marketplace compensation. It is also important to note that the companies are constantly evaluating the performance of their top executives, and it is not unusual for the companies to promote some individuals and propose pay decreases for others.

Thus, OSM does not approve all pay increases. Where appropriate, it has permitted individual pay increases based on the unique facts and circumstances of each case, while at the same time emphasizing limitations on cash and total pay. For example, neither AIG nor Ally Financial proposed any net increase in compensation for its top 25 executives for 2012. The pay raises proposed by AIG and Ally Financial were more than offset by the pay decreases proposed by these companies. Although GM did propose a net increase in compensation for 2012, its pay packages nevertheless were on average at the 50th percentile for comparable positions at comparable entities. Moreover, OSM required that more than 97 percent of the approved pay increases be in the form of stock compensation rather than cash, because the ultimate value of stock compensation is uncertain and will reflect the long-term performance of the company. In addition, the three current CEOs of the exceptional assistance companies subject to the 2012 determination process have not had any pay increase during their respective tenures.

Treasury recognizes the importance of diligent oversight and has benefited from SIGTARP's review of its work. I understand that in its 2012 report, SIGTARP made three recommendations and that OSM implemented two of those recommendations and was in the process of implementing the third when SIGTARP's 2013 report was published. With respect to SIGTARP's most recent recommendations, Treasury responded in writing stating that it will consider these recommendations.

Q.2. It has been more than 4 years since policy makers began focusing on how to fix the "too big to fail" problem and eliminate the implicit guarantee that, in a time of crisis, the Federal Government would bail out large financial institutions instead of letting them fail and pose a systemic threat to the economy. Nonetheless, the big banks now are even bigger than they were in the run-up to the crisis and appear to have retained their "too big to fail" status and the accompanying implicit guarantee. In addition to morale hazard that results from "too big to fail" status, the implicit guarantee also has market distorting effects. As columnist George Will recently wrote, large financial institutions still have "a silent subsidy—an unfair competitive advantage relative to community banks—inherent in being deemed by the Government, implicitly but clearly, too big to fail." [1]

Do you believe that the Financial Stability Oversight Council (FSOC) has the necessary authorities—for example, under Section 121 of the Dodd-Frank Act—to block expansion and in some cases mandate divestiture of large financial institutions to ward against the "too big to fail" problem?

Do you believe that FSOC should use its authorities to order divestiture only in cases of active crisis, or are there situations in which FSOC's authority to break up large banks could be done to mitigate against future risks associated with the "too big to fail" problem?

Do you believe there are further steps Congress should take to fix the "too big to fail problem?"

A.2. The Dodd-Frank Act provides the U.S. financial authorities with a wide range of tools to mitigate risks to the U.S. financial system. One such tool is the authority of the Board of Governors of the Federal Reserve System under Section 121 to take remedial measures with respect to certain financial firms that the Federal Reserve determines pose a grave threat to the stability of the U.S. financial system. Section 121 provides that, if the Federal Reserve Board determines that a large bank holding company or a nonbank financial company supervised by the Federal Reserve Board poses a grave threat to U.S. financial stability, then the Federal Reserve Board, upon the affirmative vote of at least two-thirds of the voting members of the Council then serving, must take at least one of several actions, including potentially forbidding the company from making further acquisitions or requiring the company to sell or otherwise dispose of assets. While any potential use of this authority would need to be evaluated on a company-specific basis, the Dodd-Frank Act does not limit the exercise of authority under Section 121 of the Dodd-Frank Act to specified economic conditions.

[1] *http://articles.washingtonpost.com/2012-10-12/opinions/35501753_1_banks-andrew-haldane-systemically-important-financial-institutions*

The reforms put in place by the Dodd-Frank Act provide regulators with critical tools and authorities that we lacked before the crisis to resolve large financial firms whose failure would have serious adverse effects on financial stability without requiring taxpayer assistance. The emergency resolution authority for failing firms created under Title II expressly prohibits any bailout by taxpayers. For any financial firm that is placed into receivership under this Dodd-Frank emergency resolution authority, management and directors responsible for the failed condition of the firm will be removed and shareholders will be wiped out. In addition, the law requires the largest bank holding companies to prepare "living wills" that provide a roadmap for facilitating a rapid and orderly bankruptcy.

Financial reform has also required U.S. financial institutions to become more resilient. Large, interconnected financial institutions will now be required to hold significantly higher levels of capital and liquidity. Leverage is significantly lower, reliance on short-term funding is lower, and liquidity positions have already improved such that large firms are less vulnerable in the event of a downturn.

Q.3. In her written testimony to the hearing, the Special Inspector General for TARP (SIGTARP) Christy Romero discussed the "threat of contagion" to our financial system caused by the interconnectedness of the largest institutions that existed in the run-up to the financial crisis.

Do you believe the financial system remains vulnerable to the interconnectedness of the largest institutions?

What is the Department of the Treasury doing to address risks that the interconnectedness of large financial institutions pose to our financial system?

Can you describe the metrics the Department of the Treasury uses to monitor an institution's interconnectedness and risk that it may pose to the financial system?

A.3. The financial crisis demonstrated the risks that can arise when large financial institutions are too interconnected, and showed that stress can cascade from institution to institution, placing the entire financial system at risk. The Treasury Department has been consulting with the financial regulators as they implement new protections against risks of contagion.

An important area of reform here is Title VII of the Dodd-Frank Act, which embodies comprehensive reform of derivatives. For example, the law requires that standardized derivatives contracts be cleared through a well-regulated central counterparty, thereby reducing risk to the system. If a derivatives counterparty fails, its failure is absorbed by the clearinghouse, which requires appropriate margin for all cleared derivatives, rather than this risk cascading to other firms.

The Dodd-Frank Act also limits interconnections among firms by imposing single-counterparty credit limits for the largest bank holding companies and nonbank financial companies that are designated for Federal Reserve Board supervision and enhanced prudential standards. These rules, when finalized, will restrict how much credit exposure, including exposure from derivatives, any one of these financial companies can have to any other unaffiliated firm. In addition, the Office of the Comptroller of the Currency (OCC) has acted to limit the impact of interconnectedness among certain financial institutions through the enforcement of its lending limits. These limits were recently strengthened by section 610 of the Dodd-Frank Act to include derivatives in the calculation.

Q.4. Christy Romero also provided testimony about the need for large institutions to engage in effective risk management practices and for regulators to supervise this risk management.

Do you believe the risk management practices at the largest financial institutions are adequate?

Can you describe what the Department of the Treasury is doing to supervise the risk management at the largest institutions?

A.4. I strongly believe in the importance of robust risk management at all financial companies. The Federal banking regulators have oversight over risk management as part of their supervisory authority over financial institutions under their jurisdiction. Public statements and reported regulatory actions of the agencies indicate that risk management practices at large financial institutions is a priority for the agencies.

Further, the Dodd-Frank Act contains important measures to help safeguard overall financial stability through stronger risk management practices at financial firms. The law requires bank holding companies with $50 billion or more in assets and nonbank financial companies supervised by the Federal Reserve Board to comply with enhanced prudential standards. These enhanced prudential standards require large publicly traded bank holding companies to establish a board-level risk management committee as part of more stringent enterprise-wide risk management.

Ultimately, financial institutions make errors of risk and judgment all the time, and some companies fail because of them. The test of reform is not whether it can protect banks from losses, but whether it can prevent broader damage to the economy and taxpayers.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR JOHANNS FROM MARY J. MILLER

Q.1. To the extent practicable, please update us as to the below concerns on how Treasury and the Financial Stability Oversight Council (FSOC) are approaching the analysis of firms being considered for nonbank SIFI designation.

Are different metrics being applied in the evaluation of different business models? For example, are different metrics being used to evaluate asset managers than those being used to evaluate insurance companies? To that end, can you assure us that similarly rigorous standards are being used across all nonbank business models?

A.1. The Council recognizes that a thorough evaluation of different types of nonbank financial companies must rely on different quantitative and qualitative considerations. The Council has been using a broad range of quantitative and qualitative information to evaluate nonbank financial companies, and takes into account company-specific and industry-specific information as appropriate. For example, the Council's interpretive guidance notes that financial guarantors, asset management companies, private equity firms, and hedge funds may pose risks that are not well-measured by the same quantitative thresholds as insurance companies or other entities.

Q.2. Can you estimate the time frame for the first nonbank SIFI designations to be made public? Do you anticipate them being made before prudential standards are finalized? If so, why would you not wait for the rules to be in place before designations are made?

A.2. I expect that Council will vote on an initial set of nonbank financial companies for potential designation in the near term. This may occur before the finalization of relevant enhanced prudential standards. The specifics of such standards, however, are not necessary to the Council's consideration, governed by the criteria set forth in the Dodd-Frank Act, of whether a nonbank financial company could pose a threat to U.S. financial stability.

Q.3. In September of last year, the GAO issued a report containing specific recommendations to strengthen the accountability and transparency of the FSOC's activities, as well as to enhance collaboration both amongst FSOC members themselves and between the council and outside stakeholders. I am particularly concerned about the recommendation to establish a collaborative and comprehensive framework for assessing the impact the designation of nonbank SIFIs will have on not only the impacted firms, but also the greater economy as a whole. Has anything been done since this report was issued to address this particular concern?

A.3. The Council, as described in its final rule regarding nonbank financial company designations, will annually reassess whether each designated nonbank financial company continues to satisfy the statutory standards established by the Dodd-Frank Act. Additionally, the Council intends to review, at least every 5 years, the uniform, quantitative thresholds it applies initially to identify nonbank financial companies for further evaluation. Moreover, we will review the results of the GAO's work to assess some of the impacts articulated in their recommendation and evaluate how these impacts may be relevant to the statutory criteria that the Council is required to consider when evaluating nonbank financial companies for designation.

Q.4. To a similar end, the GAO report also suggested working to better rationalize rulemakings by using professional and technical advisors such as State regulators, industry experts, and academics to assist FSOC in its decision-making process. What has been done in this regard to ensure that issues relating to nonbank supervision are being appropriately reviewed by subject-matter experts in the relevant nonbank business model?

A.4. Throughout the nonbank financial company designations process, the Council has engaged with relevant experts and stakeholders with regard to the business models of firms under consideration for potential designation. Council members and their staffs have substantial expertise regarding a broad range of financial companies and activities. With respect to State regulators in particular, State banking, State insurance, and State securities regulators are Council members and participate actively in the discussions of the Council and its committees. In addition, the Council is coordinating and consulting with the relevant primary financial regulators, which, in the case of insurers, includes the appropriate State insurance supervisors. Similarly, the Council and OFR have engaged with market participants in undertaking the analysis of asset management.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM MARY J. MILLER

Q.1. In a September 2012 report discussing the Financial Stability Oversight Council (FSOC), the GAO criticizes the Council's lack of transparency regarding its deliberations on money market fund regulation and concludes, among other things, that the Council's minutes from a closed meeting in which the issue was discussed "lacked any content of the discussion."

What steps will you take to make these policy discussions more transparent to the public?

A.1. The Council appreciates the work of the GAO and the important oversight function that it provides, and has taken or plans to take a number of actions in response to the recommendations made in its September report. Specifically, with regard to potential money market mutual fund (MMF) reforms, the Council recently issued proposed recommendations under Section 120 of the Dodd-Frank Act for public comment. The proposed recommendations' discussion of the risks posed by MMFs, and the questions they ask about the proposed reforms, reflect the Council's deliberations. The initial 60-day comment period was extended by 1 month to February 15, 2013, and approximately 150 comments were received on the proposed reforms.

The Council is firmly committed to transparency and to holding open meetings, and it closes meetings only when appropriate. The Council's transparency policy commits the Council to hold two open meetings each year, and the Council has held ten open meetings in its first 2½ years. However, the Council must continue to balance its responsibility to be transparent with its central mission to monitor emerging threats to financial stability. This frequently requires discussion of supervisory and other market-sensitive data during Council meetings, including information about individual firms, transactions, and markets that may only be obtained if maintained on a confidential basis. Continued protection of this information is necessary in order to prevent destabilizing market speculation that could occur if that information were to be disclosed.

Q.2. What do you generally believe the time frame is for the first nonbank SIFI designations to occur?

I understand that a few nonbank companies are now in "Stage 3" of the review process, but when do you think one or more of those designations will become final and will be publicly announced?

A.2. I expect that the Council will vote on an initial set of nonbank financial companies for potential designation in the near term. The names of any firms that are designated will be made public after a final designation.

Q.3. Will nonbank SIFI designations occur before prudential standards are established for nonbank SIFIs?

If so, designated firms would face uncertainty; why not wait for rules to be in place before designations are made?

A.3. The first designations may occur before the enhanced prudential standards are finalized. The Council does not believe it is necessary or appropriate to postpone the evaluation of nonbank financial companies pending finalization of these rules, which are not essential to the Council's consideration of whether a nonbank financial company could pose a threat to U.S. financial stability.

Q.4. Section 120 of the Dodd-Frank Act states that "[t]he Council shall consult with the primary financial regulatory agencies [. . .] for any proposed recommendation that the primary financial regulatory agencies apply new or heightened standards and safeguards for a financial activity or practice." In its November 2012 release on money market fund regulatory proposals, FSOC states that "in accordance with Section 120 of the Dodd-Frank Act, the Council has consulted with the SEC staff." It is my understanding that FSOC did not consult with any of the SEC Commissioners serving at the time.

Given that the SEC is solely governed by the commissioners, and especially considering that SEC staff serves at the will of the SEC Chairman rather than all Commissioners, how would such consultations with staff fulfill this statutory obligation going forward?

A.4. In developing its proposed recommendations for money market mutual fund reform, the Council consulted with the SEC staff. The Council takes seriously its obligation to consult with financial regulatory agencies under statutory provisions such as Section 120 of the Dodd-Frank Act, and the Council regularly does so. These consultations have been discussions and coordination with staff, including senior staff, of the relevant agencies, which is consistent with the traditional way that agencies Government-wide have performed interagency consultations under numerous statutes. In addition, the Council may consult with individuals who lead agencies, whether individually or as members of an agency board or commission. Certain of these individuals, including the Chairman of the SEC, are members of the Council and participate in Council deliberations. In all cases, the Council welcomes the input of such individuals.

Q.5. What research has FSOC done to determine the reduction in assets held in money market funds that could result from the proposed section 120 recommendations?

Have you done anything to quantify the economic effect of a substantial shift in assets from prime money market funds to Treasury money market funds, banks, or unregulated investment funds?

A.5. Under Section 120 of the Dodd-Frank Act, the Council is required to "take costs to long-term economic growth into account" when recommending new or heightened standards and safeguards for a financial activity or practice. If the SEC accepts a final recommendation issued by the Council regarding money market mutual fund reform, it is expected that the SEC would implement the recommendation through a rulemaking, subject to public comment, that would consider the economic consequences of the implementing rule as informed by the SEC staff's own economic study and analysis.

Section VI of the FSOC's proposed recommendations outlines the Council's preliminary analysis regarding the potential impact of the proposed reforms on long-term economic growth and requested comment from the public on that analysis. In that section, the Council stated that it expects that the proposed recommendations would significantly reduce the risk of runs on MMFs and, accordingly, lower the risk of a significant long-term cost to economic growth. In addition, the Council recognizes that regulated and unregulated or less-regulated cash management products other than MMFs may pose risks that are similar to those posed by MMFs, and that further MMF reforms could increase demand for non-MMF cash management products. The Council sought comment on this issue and other possible reforms that would address risks that might arise from a migration to non-MMF cash management products.

The Council requested comment on its proposed analysis, including what, if any, impact the proposed recommendations could have on investor demand for MMFs. We are in the process of evaluating the comments the Council received on its proposed recommendations and will evaluate the costs to long-term economic growth in light of these comments when formulating a final recommendation.

Q.6. Regarding the Volcker Rule, some have suggested that the banking agencies should just go ahead and issue their final rule without waiting to reach agreement with the Securities and Exchange Commission and Commodities Futures Trading Commission, which have to issue their own rules. This scenario could result in there being more than one Volcker Rule, which would create significant confusion about which agency's rule would apply to which covered activity.

Given the statutory directive in Dodd-Frank that Treasury serve as chief coordinator of this "coordinated rulemaking," can you comment on the current status of these interagency discussions as well as your thoughts on the possibility of multiple Volcker Rules?

A.6. Since the issuance of the Council's study on the Volcker Rule in January 2011, Treasury has been working hard to fulfill the statutory mandate to coordinate the regulations issued under the Volcker Rule. To meet this obligation, Treasury staff actively participate with the three Federal banking agencies and the SEC and CFTC in the interagency process working to develop these rules. This process includes regular meetings which serve as constructive forums for the agencies to deliberate on key aspects of the rules. This process resulted in the issuance of proposed regulations that were substantively identical, demonstrating a substantial commitment among the agencies to a coordinated approach, and continues as regulators work to finalize the rules. We take Treasury's role as coordinator very seriously and remain committed to working with the rulemaking agencies towards a substantively identical final rule.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM DANIEL K. TARULLO

Q.1. Given how complex it is to determine whether a trade is a hedge or a proprietary trade, it appears the real issue is whether a trade threatens the safety and soundness of the bank. What benchmark does your agency use to determine whether a particular activity is or is not "hedging"? How does your agency determine whether the trade presents risks to the safety and soundness of a financial institution?

A.1. Section 619 generally prohibits banking entities from engaging in proprietary trading for the purpose of profiting from short-term price movements, and from acquiring or retaining interests in, or having certain relationships with, hedge funds and private equity funds. In each case the statute explicitly provides certain exemptions from these prohibitions, as well as limitations on permitted activities. Among the exceptions is an exception for risk-mitigating hedging activities.

To implement the exception for risk-mitigating hedging activities, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, (the Agencies) proposed requirements designed to enhance the risk-monitoring and management of hedging activities and to ensure that these activities are risk-mitigating. Among the requirements the Agencies proposed included a requirement that the banking entity establish and follow formal policies and procedures governing hedging activities and defining the instruments and strategies that could be used for hedging, documentation requirements explaining the hedging strategy, an internal compliance audit requirement, and requirements that incentive compensation paid to traders engaged in hedging not reward proprietary trading. This multifaceted approach was intended to limit potential abuse of the hedging exemption while not unduly constraining the important risk management function that is served by a bank entity's hedging activities.

Determining whether any trading activity represents a risk to safety and soundness is typically made in connection with the supervisory process and depends on the specific facts and circumstances. In accordance with supervisory guidance on risk management, banks are generally required to have internal controls and written policies and procedures regarding how their trading and hedging strategies ensure that all risks are effectively managed and subject to limits, that risk measures and prices are independently validated, and that risks are reported to management as appropriate. The agencies then use the examination process to review these policies and procedures as they are applied to the trading and hedging activities of the firm.

Q.2. Federal Reserve, FDIC, and OCC have issued proposed rules to implement Dodd-Frank and Basel III capital requirements for U.S. institutions. Late last year, your agencies pushed back the effective date of the proposed Basel III rules beyond January 1, 2013. Given the concerns that substantially higher capital requirements will have a negative impact on lending, are your agencies using this extra time to conduct a cost-benefit analysis about the impact of the proposed rules on the U.S. economy, availability, and cost of credit, cost of insurance, and the regulatory burden on institutions, before implementing the final rules?

A.2. In developing the Basel III-based capital requirements, the Board and the other Federal banking agencies conducted an impact analysis based on regulatory reporting data to estimate the change in capital that banking organizations would be required to hold to meet the proposed minimum capital requirements. Based on the agencies' analysis, the vast majority of banking organizations currently would meet the fully phased-in minimum capital requirements. The agencies proposed a transition period that would allow those organizations that would not meet the proposed minimum requirements to adjust their capital levels. In addition, quantitative analysis by the Macroeconomic Assessment Group, a working group of the Basel Committee on Banking Supervision, found that the stronger Basel III capital requirements would lower the probability of banking crises and their associated economic output losses while having only a modest negative impact on gross domestic product and lending costs, and that the potential negative impact could be mitigated by phasing in the requirements over time.

The agencies received over 2,500 comment letters regarding the proposals. The original comment period was extended to allow interested persons more time to understand, evaluate, and prepare comments on the proposals. The Board explicitly sought comment on significant alternatives to the proposed requirements applicable to covered small banking organizations that would minimize their impact on those entities, as well as on all other aspects of its analysis. The Board is carefully considering the commenters' views on and concerns about the effects of the notices of proposed rulemaking on the U.S. economy and on banking organizations. Prior to adopting any final rule, the Board will conduct a final regulatory flexibility analysis under the Regulatory Flexibility Act. [1]

Before issuing any final rule, the Board will also prepare an analysis under the Congressional Review Act (CRA). [2] As part of this analysis, the Board will assess whether the final rule is a "major rule," meaning the rule could (1) have an annual effect on the economy of $100 million or more; (2) increase significantly costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or (3) have significant adverse effects on competition, employment, investment, productivity, or innovation. Consistent with the CRA, any such analysis will be provided to Congress and the Government Accountability Office.

Q.3. Given the impact that the Qualified Mortgages (QM) rules, the proposed Qualified Residential Mortgages (QRM) rules, the Basel III risk-weights for mortgages, servicing, escrow, and appraisal rules will have on the mortgage market and the housing recovery,

[1] 5 U.S.C. § 601, et seq.
[2] 5 U.S.C. § 801-808.

it is crucial that these rules work in concert. What analysis has your agency conducted to assess how these rules work together? What is the aggregate impact of those three rules, as proposed and finalized, on the overall mortgage market as well as on market participants?

A.3. The Dodd-Frank Act requires the Federal banking agencies and other agencies to implement a number of requirements that relate to mortgages and the mortgage market, such as those you note in your question. The agencies are mindful of the interaction and interrelationship of these requirements as we develop rules to implement these statutory provisions.

For example, the Board is required under section 941 of the Dodd-Frank Act, along with six other agencies (including the Federal banking agencies), to implement risk retention requirements and define QRM as an exemption to those requirements. By statute, all entities that meet the statutory definition of "securitizer" must meet the risk retention requirements. Under section 941, the definition of QM serves as the outer limit of the definition of QRM. The Board and the other agencies that must implement section 941 are currently discussing how to define QRM in light of the CFPB's recent determination of the final definition of QM.

In the proposed rulemakings to revise regulatory capital requirements released in June 2012, the Board and the other Federal banking agencies proposed to revise the risk weighting for residential mortgages based on loan characteristics and loan-to-value ratio. These requirements would apply to banks, bank holding companies, and savings and loan holding companies. The Board and the other banking agencies have received many comments on the proposed risk weights for mortgages and the Board is carefully taking into consideration the concerns raised in those comments, including concerns regarding compliance burden from various mortgage-related regulations, and the effect of these proposals on the availability of mortgage credit, in its discussions with the other agencies on how to move the proposed rulemakings forward.

The Board has long been committed to considering the costs and benefits of its rulemaking efforts and takes into account all comments and views from the public on the costs and benefits of a proposed rulemaking. The Board is sensitive to concerns that various regulatory changes could lead to more expensive mortgages and reduce access to credit, and will carefully consider all comments on rulemakings in which it participates.

Q.4. Under the Basel III proposals, mortgages will be assigned to two risk categories and several subcategories, but in their proposals the agencies did not explain how risk weights for those subcategories are determined and why they are appropriate. How did your agency determine the appropriate range for those subcategories?

A.4. During the recent market turmoil, the U.S. housing market experienced significant deterioration and unprecedented levels of mortgage loan defaults and home foreclosures. The causes for the significant increase in loan defaults and home foreclosures included inadequate underwriting standards, the proliferation of high-risk mortgage products, expansion of the practice of issuing mortgage loans to borrowers with undocumented income, and a precipitous decline in housing prices coupled with a rise in unemployment.

In the capital proposal, the agencies sought to improve the risk sensitivity of the regulatory capital rules for mortgages by raising capital requirements for risker mortgages, including nontraditional product types, while lowering requirements on traditional residential mortgage loans with lower credit risk. The ranges of the factors were developed on an interagency basis utilizing expert supervisory judgments including policy experts and bank examiners. The agencies also considered supervisory and mortgage market data in the formulation of these risk weights, which are generally comparable to the risk weights assigned to mortgage exposures by banking organizations that use the internal ratings based methodology.

The Board and the other agencies have received many comments on the mortgage proposals and the Board is carefully taking these comments into consideration in determining capital requirements for mortgages.

Q.5. The Senate Banking Committee Report on Dodd-Frank made it clear that the law did not mandate insurers use GAAP accounting. However, the proposed Basel III rules would require insurance enterprises to switch to GAAP. How will this change impact insurance companies, both practically and financially?

A.5. The proposed capital requirements would apply on a consolidated basis to bank holding companies and savings and loan holding companies (SLHCs), some of which are primarily engaged in the insurance business. Currently, capital requirements for insurance companies are imposed by State insurance laws on a legal entity basis and there are no State-based, consolidated capital requirements that cover holding companies for insurance firms.

In the proposals, the Board sought to meet the legal requirements of section 171 of the Dodd-Frank Act while incorporating flexibility for depository institution holding companies significantly engaged in the insurance business. Section 171 of the Dodd-Frank Act requires the agencies to apply consolidated minimum risk-based and leverage capital requirements for depository institution holding companies, including SLHCs, that are no less than the generally applicable capital requirements that apply to insured depository institutions under the prompt corrective action framework. The "generally applicable" rules use generally accepted accounting principles (GAAP) as the basis for regulatory capital calculations.

The proposed requirement that SLHCs calculate their capital standards on a consolidated basis using a framework that is based on GAAP standards is consistent with section 171 of the Dodd-Frank Act and would facilitate comparability across institutions. In contrast, the statutory accounting principles (SAP) framework for insurance companies is a legal entity-based framework and does not provide consolidated financial statements.

The Board received many comments on the proposed application of consolidated capital requirements to savings and loan holding companies, including on cost and burden considerations for those firms that currently prepare financial statements based solely on SAP. The Board will consider these comments carefully in determining how to apply regulatory capital requirements to bank holding companies and SLHCs with insurance operations consistent with section 171 of the Dodd-Frank Act.

Q.6. Pursuant to Dodd-Frank, FSOC can designate as Systemically Important Financial Institution (SIFI) certain nonbank financial companies that are "predominately engaged in financial activities," resulting in extra scrutiny for that company. There were considerable concerns during the Dodd-Frank debate that a broad definition would encompass too many entities. In April of last year those concerns were reaffirmed when the Federal Reserve's proposed definition captured many activities not traditionally viewed as financial or systemically risky. Does the Federal Reserve intend to reconsider its proposed definition of "predominately engaged in financial activities" to address concerns raised in public comment letters?

A.6. The Dodd-Frank Act defines the type of firm that is eligible to be designated by the Financial Stability Oversight Council (FSOC) for enhanced supervision by the Board. These provisions apply only to firms that derive 85 percent or more of their annual gross revenues from financial activities or have 85 percent or more of the firm's consolidated assets in assets related to financial activities. [3] For purposes of these provisions, financial activities are defined by reference to section 4(k) of the Bank Holding Company Act (BHC Act). [4]

In April 2012, the Board invited public comment on a proposed rule implementing these provisions (the April 2012 proposal). The April 2012 proposal noted that the list of financial activities published by the Board in its Regulation Y incorporates various conditions that the Board has imposed on bank holding companies to ensure that they engage in these financial activities in a safe and sound manner. Other conditions were imposed by the Board because they were required by other provisions of law, such as the Glass-Steagall Act. The April 2012 proposal sought comment on whether any of these conditions were essential to the definition of an activity as financial. As you note, the public provided a number of comments on the Board's proposal, including with respect to the scope of the proposed definitions and the treatment of physically settled derivatives transactions. The Board carefully considered these comments in formulating the final rule, which the Board approved on April 3, 2013. The final rule made a number of modifications to address concerns raised by commenters, including changes that reduced the scope of the original proposal. It is important to note that the Board's regulation defining activities that are "financial" is based on the list of financial activities referenced by Congress in the Dodd-Frank Act, and that the conduct of these financial activities does not itself create any burden or obligation on any entity until and unless the FSOC determines, in accordance with the standards and procedures set forth in the Dodd-Frank Act, that the entity could pose a threat to the financial stability of the United States.

[3] Section 102(a)(6) of the Dodd-Frank Act; 12 U.S.C. §5311(a)(6).
[4] Id.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNER FROM DANIEL K. TARULLO

Q.1. As you know, a number of people including Sheila Bair have been advocates of using a simple leverage ratio as the primary measure of banks' capital strength. Would focusing on a simple leverage ratio, using the Basel III definition of leverage which includes key off balance sheet exposures, help cut through the noise of risk weighting and models and cross border differences, and give us all greater confidence that large banks are holding a good amount of high quality capital?

A.1. Strong capital regulation is central to an effective prudential regulatory regime for financial institutions. Experience has shown that no single form of capital requirement captures all relevant risks and, standing alone, any capital requirement is subject to sometimes extensive regulatory arbitrage. Consequently, banking regulation evolved historically from a primary reliance on simple leverage ratios to a dual focus on both leverage and risk-weighted capital requirements. These requirements must be complementary and mutually reinforcing. This relationship has obviously been changed by the substantial increase in the risk-based ratio resulting from the new minimum and conservation buffer requirements of Basel III. The existing U.S. leverage ratio does not take account of off-balance-sheet assets, which are significant for many of the largest firms. The new Basel III leverage ratio does include off-balance-sheet assets, but it may have been set too low. Thus, the traditional complementarity of the capital ratios might be maintained by using Section 165 to set a higher leverage ratio for the largest firms. Additionally, it is important to note that the stress testing regime for large banks established by the Federal Reserve, consistent with its mandate under Dodd-Frank, provides an important additional capital measure—one that is both risk-sensitive and, unlike traditional capital measures, forward looking.

Q.2. The FDIC and Fed have joint jurisdiction over the completion of living wills from large firms. Now, I don't think anyone expected the first year of plans to be perfect, but can you remind everyone, for the FDIC and Fed to approve the plans, isn't the standard that they have to show how normal liquidation like bankruptcy or FDIC resolution could work under reasonable circumstances? And what progress have the plans made in getting firms to think through their structure, better inform you as regulators, and lead to simplification and rationalization?

A.2. The Dodd-Frank Act requires the Federal Deposit Insurance Corporation and the Federal Reserve Board (the "agencies") to review the resolution plans, or "living wills," filed by the firms and to notify a firm that its plan is deficient if the agencies jointly determine that the plan is not credible or would not facilitate an orderly liquidation of the firm under Title 11 of the U.S. bankruptcy code. The agencies issued a joint final rule implementing the living wills requirement in November 2011.

The agencies have received resolution plans from 11 of the largest and most complex firms. These plans constitute the first step in an iterative process and will provide the foundation for developing increasingly robust annual resolution plans. The initial submissions focused on the key elements set out in the joint rule, including identifying critical operations and core business lines, developing a robust strategic analysis, and identifying and describing the interconnections and interdependencies among the firm's material entities.

The economic circumstances that could accompany the financial distress or failure of a firm in the future are not knowable in advance. Nonetheless, a resolution plan should be sensitive to the economic conditions surrounding the financial distress or failure of a firm. To assist in establishing assumptions for economic conditions surrounding a firm's financial distress or failure, filers are required to take into account that the firm's material financial distress or failure could occur under the "baseline," "adverse," and "severely adverse" economic conditions developed by the Federal Reserve Board pursuant to stress test requirements of section 165(i)(1)(B) of the Dodd-Frank Act. Firms were permitted to assume that failure would occur only under the baseline scenario for their initial submission with the expectation that subsequent iterations of the resolution plans would begin to address the other scenarios. As part of the iterative planning process, the agencies expect to evaluate the effectiveness of the scenarios in calibrating plan sensitivity to economic conditions surrounding the financial distress or failure of a firm.

The firms devoted a significant amount of time and resources in developing their initial resolution plans as well as in establishing the processes, procedures, and systems necessary for annual updates. Moreover, the agencies have been engaged in an ongoing dialogue with these firms to develop, focus, and clarify their plans. Our initial interactions with the firms demonstrate clearly that preparing resolution plans is helping the firms and the supervisors learn a great deal about the organizational structure, inter-relationships, and exposures of these firms.

Q.3. I believe that the Basel III accords are an important tool for reducing risks within the financial system and ensuring level playing fields in international markets. However, I am concerned that there are a number of areas where the agreements and the Federal Reserve's proposals for implementing them have not been adequately tailored to recognize differences in accounting standards in the U.S. and other jurisdictions and the variety of business models in the U.S. Can you describe what steps the Federal Reserve is taking to tailor the proposals to the insurance business model?

A.3. Section 171 of the Dodd-Frank Act requires that the Federal Reserve Board (the "Board") establish minimum leverage capital requirements and minimum risk-based capital requirements for depository institution holding companies and for financial companies designated by the Financial Stability Oversight Council that are not less than the leverage and risk-based capital requirements that were generally applicable to banks and savings associations on July 21, 2010. In developing these capital requirements, the Board sought to meet the requirements of the Dodd-Frank Act, to promote capital adequacy at all depository institution holding companies, and, to the extent permitted by section 171, to incorporate adjustments for depository institution holding companies significantly engaged in the insurance business. In that regard, the Board invited public comment on proposals to address the unique character of insurance companies through specific risk weights for policy loans and nonguaranteed separate accounts, which are typically held by insurance companies, but not banks. The proposals also would allow the inclusion of surplus notes, a type of financial instrument issued primarily by insurance companies, in tier 2 capital, provided that the notes meet the relevant eligibility criteria.

The Board received numerous comments on the capital requirements proposed last year as they would apply to insurance companies and is carefully considering information provided and the concerns raised by commenters.

Q.4. Can you describe the steps the Federal Reserve is taking to ensure that community and midsize banks are not forced to comply with complex standards better suited to larger and more complex institutions?

A.4. In developing safety and soundness rules, the Federal Reserve Board and the other Federal banking agencies must strike the right balance between safety and soundness concerns and the costs associated with implementation, including the impact on community banking. It is important to note that numerous items in the Basel III proposal, and in other recent regulatory reforms, are focused on larger institutions and would not be applicable to community banking organizations. These items include the countercyclical capital buffer, the supplementary leverage ratio, enhanced disclosure requirements, the advanced approaches risk-based capital framework, stress testing requirements, the systemically important financial institution capital surcharge, and market risk capital reforms. This targeted approach should improve the competitive balance between large and small banks, while improving the overall resiliency of the financial sector.

Midsize banking organizations are also exempt from most of the requirements referred to above, including the countercyclical capital buffer, the supplementary leverage ratio, and the advanced-approaches risk-based capital framework. However, they would need to meet basic stress testing requirements that have been specifically tailored as required by the Dodd-Frank Act, for the midsize banking business model, as finalized in October 2012. These requirements are less stringent than the stress testing framework applied to banking organizations with more than $50 billion in assets. Additionally, midsize banks have been given a longer time frame to meet these requirements than their larger counterparts.

Q.5. What steps is the Federal Reserve taking to examine the appropriateness and impact of the risk weights for mortgage-backed securities including those that contain nonrecourse loans?

A.5. During the recent market turmoil, the U.S. housing market experienced significant deterioration and unprecedented levels of mortgage loan defaults and home foreclosures, which, in turn, caused mortgage-backed securities (MBS) to incur unprecedented losses. The causes for the significant increase in loan defaults and home foreclosures included inadequate underwriting standards, the proliferation of high-risk mortgage products, the practice of issuing mortgage loans to borrowers with undocumented income and a precipitous decline in housing prices coupled with a rise in unemployment.

In the capital proposal, the Federal Reserve Board and the other Federal banking agencies (the "agencies") sought to improve the risk sensitivity of the regulatory capital rules for mortgages by raising capital requirements for risker mortgages, including non-traditional product types, while lowering requirements on traditional residential mortgage loans with lower credit risk. The ranges of the factors were developed on an interagency basis utilizing expert supervisory judgments including policy experts and bank examiners. The agencies also considered supervisory and mortgage market data in the formulation of these risk weights, which are generally comparable to the risk weights assigned to mortgage exposures by banking organizations that use the internal ratings based methodology.

The agencies received numerous comment letters on the proposals for risk weighting mortgages. The Federal Reserve Board is carefully considering the commenters' views on and concerns about the effects of the proposed mortgage treatment on the U.S. economy and on banking organizations.

Q.6. What progress is being made to ensure that Basel III is implemented with a reasonable degree of uniformity and transparency across jurisdictions?

A.6. The Federal Reserve Board has consistently favored a uniform and transparent implementation of the Basel III reforms across jurisdictions. To this end, staff has contributed to international assessments organized by the Basel Committee of the participating financial jurisdictions and highlighted any divergences they encountered in their assessments. Similarly, our international colleagues are tracking progress by the United States to meet the reforms. We remain committed to ensuring consistent implementation, as this decreases opportunities for cross-border regulatory arbitrage and keeps U.S. banks on equal footing with their foreign competitors.

Q.7. The statutory language for funds defined under the Volcker Rule pointedly did not include venture funds, however the definition in the proposed rule seemed to indicate that venture funds would be covered. In addition to exceeding the statutory intent of Congress, this has created uncertainty in the market as firms await a final rule and refrain from making commitments which might be swept up in the final version of the Volcker Rule. Can you clarify whether venture funds are covered by the Volcker Rule?

A.7. One of the restrictions in section 619 applies to hedge and private equity funds and prohibits a banking entity from acquiring or retaining an interest in, or having certain relationships with, hedge funds and private equity funds, subject to certain exemptions. Section 619 specifically defines the terms "hedge fund" and "private equity fund" to mean an issuer that would be an investment company as defined in the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Depository Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission (the "agencies") may, by rule, determine.

See 12 U.S.C. §1851(h)(2). The statutory language contains no reference to venture capital funds. The agencies requested comment on whether venture capital funds should be excluded from the definition of covered fund, and, if so, what scope of authority the agencies have under the statute to exempt venture capital funds, and how to define venture capital fund. The agencies received over 18,000 comments regarding the proposed implementing rules, including comments that specifically addressed the issues of venture capital funds and venture capital investments. The agencies are currently considering these comments as we work to finalize implementing rules.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM DANIEL K. TARULLO

Q.1. As you know, the Federal Reserve and the Office of the Comptroller of the Currency (OCC) recently announced settlements with mortgage servicers subject to consent orders issued by the Federal Reserve and the OCC in April 2011 regarding unsafe and unsound practices related to residential mortgage loan servicing and foreclosure processing. The terms of the settlement include $3.6 billion in cash payments to more than 4 million borrowers and $5.7 billion in additional assistance.

Can you explain in what situations the Board of Governors of the Federal Reserve votes on whether to accept a settlement?

A.1. Under the Federal Reserve Board's (the Board) Rules Regarding Delegation of Authority, there is delegated authority for Board staff to enter into or approve modifications to consent cease-and-desist orders, such as the recently announced agreements with mortgage servicers (12 CFR §§265.6(e)(1) and (e)(2)). Any Board member may request review of any delegated action (12 CFR §265.3(a)). In many cases, including matters involving significant enforcement actions, such as the mortgage servicer agreements, staff with delegated approval authority consult with members of the Board prior to exercising that authority to obtain their views on whether consideration by the Board is appropriate.

Q.2. When no vote occurs, can you indicate what official at the Federal Reserve has decision-making authority over whether to accept a settlement?

A.2. The Board's general counsel (or his delegee), with the concurrence of the director of the Board's Division of Banking Supervision and Regulation (or his delegee), has delegated authority to approve consent cease-and-desist orders as well as modifications to consent cease-and-desist orders, such as the recently announced agreements with mortgage servicers (12 CFR §§265.6(e)(1) and (e)(2)).

Q.3. Did a vote occur with this particular settlement?

A.3. Board staff frequently consulted with Board members before exercising delegated authority to approve the amendments to the foreclosure consent orders. A vote did not occur.

Q.4. It has been more than 4 years since policy makers began focusing on how to fix the "too big to fail" problem and eliminate the implicit guarantee that, in a time of crisis, the Federal Government would bail out large financial institutions instead of letting them fail and pose a systemic threat to the economy. Nonetheless, the big banks now are even bigger than they were in the run-up to the crisis and appear to have retained their "too big to fail" status and the accompanying implicit guarantee. In addition to morale hazard that results from "too big to fail" status, the implicit guarantee also has market distorting effects. As columnist George Will recently wrote, large financial institutions still have "a silent subsidy—an unfair competitive advantage relative to community banks—inherent in being deemed by the Government, implicitly but clearly, too big to fail."

Do you believe that the Financial Stability Oversight Council (FSOC) has the necessary authorities—for example, under Section 121 of the Dodd-Frank Act—to block expansion and in some cases mandate divestiture of large financial institutions to ward against the "too big to fail" problem?

A.4. The Dodd-Frank Act contains a number of provisions that are intended to address potential threats to U.S. financial stability and address the "too big to fail" problem. Of course, the Financial Stability Oversight Council (FSOC) has the authority under section 113 to subject a nonbank financial company to supervision by the Federal Reserve Board (Board) if the FSOC determines that the company's material financial distress or its activities could pose a threat to U.S. financial stability. The FSOC has implemented a robust process for assessing threats posed by nonbank financial companies and is actively reviewing companies pursuant to that process.

The Dodd-Frank Act also has a variety of provisions that address the growth of large financial companies. Section 622 imposes a concentration limit on large financial companies, including banks, bank holding companies, savings and loan holding companies, companies that control an insured depository institution, nonbank financial companies designated by the FSOC for supervision by the Board, and foreign banks treated as bank holding companies. Under this statutory limit, a large financial company may not merge, consolidate with, or acquire all or substantially all of the assets or control of another company, if the total consolidated liabilities of the resulting company would exceed 10 percent of the liabilities of all large financial companies.

In addition, the Dodd-Frank Act revised various provisions of the banking laws to require the Federal banking agencies to consider the risk that acquisitions of insured depository institutions and large nonbanking entities pose to the stability of the U.S. banking or financial system. For example, section 163 of the Dodd-Frank Act requires large bank holding companies and nonbank financial companies supervised by the Board to provide prior notice to the Board of a proposed acquisition of ownership or control of any voting shares of a financial company with assets of $10 billion or more, so that the Board may consider the extent to which the proposed acquisition would result in greater or more concentrated risks to global or U.S. financial stability or the U.S. economy.

Section 121 authorizes the Board, with consent of two-thirds of the voting members of the FSOC, to take certain steps if the Board determines that a large bank holding company or a nonbank financial company supervised by the Board poses a grave threat to the financial stability of the United States. These steps include limiting the ability of the company to grow through mergers or acquisitions, restricting the ability of the company to offer financial products, requiring the termination of certain activities, or imposing conditions on the manner in which the company conducts one or more activities. If the Board determines that these actions are inadequate to mitigate a threat to U.S. financial stability, the Board, with the consent of the FSOC, may require the company to sell or otherwise transfer assets to unaffiliated entities.

These provisions of the Dodd-Frank Act, in combination with other provisions that establish an orderly liquidation mechanism and enhanced prudential standards for large financial institutions, represent important developments in addressing threats posed by large financial companies to U.S. financial stability. As implementation of the Dodd-Frank Act currently remains underway, the Board believes that it is too early to determine whether further legislative action is necessary.

Q.5. Do you believe that FSOC should use its authorities to order divestiture only in cases of active crisis, or are there situations in which FSOC's authority to break up large banks could be done to mitigate against future risks associated with the "too big to fail" problem?

A.5. As described previously, section 121 of the Dodd-Frank Act authorizes the Board to take certain actions, with the approval of two-thirds of the FSOC, to restrict an institution's activities if the company poses a grave threat to U.S. financial stability. The Board may require the institution to divest assets if such action is necessary to mitigate the grave threat posed by the company. This authority requires a finding that the firm poses a grave threat to U.S. financial stability, and does not require a finding that the financial system is in active crisis.

Q.6. Do you believe there are further steps Congress should take to fix the "too big to fail problem"?

A.6. The Dodd-Frank Act and Basel III provide a number of important tools for addressing the "too big to fail" problem, including enhanced prudential standards and higher capital requirements for bank holding companies with total consolidated assets of $50 billion or more and nonbank financial companies designated by the FSOC for Board supervision, an orderly resolution authority for large financial firms, living wills, stress testing, and central clearing and margin requirements for derivatives, among other provisions. The Board and other U.S. regulators are now in the process of implementing these reforms.

In addition, as described previously, section 622 of the Dodd-Frank Act imposes a concentration limit on large financial companies that provides that a large financial company may not merge, consolidate with, or acquire all or substantially all of the assets or control of another company, if the total consolidated liabilities of the resulting company would exceed 10 percent of the liabilities of all large financial companies. In addition, the Board and the other Federal banking agencies are required to consider the risk to the stability of the U.S. banking or financial system of a proposed merger or acquisition involving bank holding companies and insured depository institutions.

Completion of this agenda will be very significant. Still, I believe that more is needed, particularly in addressing the risks posed by short-term wholesale funding markets. We should be considering ways to use our existing authority in pursuit of three complementary ends: (1) ensuring the loss absorbency needed for a credible and effective resolution process, (2) augmenting the going-concern capital of the largest firms, and (3) addressing the systemic risks associated with the use of wholesale funding.

Q.7. In her written testimony to the hearing, the Special Inspector General for TARP (SIGTARP) Christy Romero discussed the "threat of contagion" to our financial system caused by the interconnectedness of the largest institutions that existed in the run-up to the financial crisis.

Do you believe the financial system remains vulnerable to the interconnectedness of the largest institutions?

A.7. As demonstrated in the 2007–2008 financial crisis, interconnectedness among large financial institutions poses risks to financial stability. The effects of one large financial institution's failure or near collapse may be transmitted and amplified by bilateral credit exposures between large, systemically important companies. And even in the absence of direct bilateral relationships, the failure of a large financial institution can place other financial institutions under stress because of indirect relationships. For example, following the failure of a large financial institution, short-term creditors may try to reduce their exposure to other firms, depriving those firms of liquidity. While there are a number of efforts underway to improve the stability and resiliency of our financial system (see below), interconnectedness among large financial institutions still poses risk to the financial system.

As we implement financial reform, however, it is important to note that interconnectedness is also a means by which financial and economic activity is intermediated throughout the financial system. Accordingly, efforts to address risks posed by interconnectedness must strike a balance between the goals of reducing systemic risk and preserving the ability of the financial sector to provide credit to households and businesses.

Q.8. What is the Department of the Treasury doing to address risks that the interconnectedness of large financial institutions pose to our financial system?

A.8. A number of regulatory initiatives are underway to limit the risks that interconnectedness poses to the financial system.

First, more robust prudential standards for financial institutions will likely mitigate risks associated with interconnectedness, both by (a) reducing the probability that any given financial institution will fail and (b) increasing the ability of other financial institutions to absorb the knock-on effects of such failure. Thus, Basel III capital and liquidity standards should reduce the chances of the kind of financial distress among large financial institutions observed in

2008. The Basel III reforms, in particular, will increase the amount of capital banks are required to hold against exposures to other financial firms and against over-the-counter derivatives exposures. The single-counterparty concentration limits required under section 165(e) of the Dodd-Frank Act will also serve as a check on interconnectedness. Under the Board's proposal to implement that section, exposures between major covered companies and major counterparties would be subject to a tighter limit than other exposures, reducing the risks that arise from interconnectedness among the largest firms.

Certain market reforms that are underway will also limit interconnectedness. Among these, derivative market reforms, including clearing requirements and margin requirements on uncleared derivatives, will reduce the direct credit exposure that large financial institutions have with each other through derivative transactions.

Finally, the supervisory process has changed since 2008 to more closely monitor and evaluate the connections that large financial institutions maintain with each other, putting supervisors in a better position to respond to interconnectedness.

Q.9. Can you describe the metrics the Department of the Treasury uses to monitor an institution's interconnectedness and risk that it may pose to the financial system?

A.9. Interconnectedness among financial institutions arises from a number of distinct sources, including connections through asset markets and funding channels. As a result, the interconnectedness and risk of a financial institution must be characterized using an approach that is both holistic and systemic, but that also adapts to changing conditions and market practices.

The Board is now engaged in a number of information collections that are aimed at better assessing the risk and interconnectedness of large financial institutions. For example, the supervisory stress tests that inform the comprehensive capital plan and review inform our view on the risk profile of large banks. The stress tests can be useful for identifying banks that are interconnected through common asset exposures that are revealed during periods of financial stress, which is when interconnectedness presents the greatest risk to the financial system.

As another example, the Board, along with other supervisors from other jurisdictions, has begun to collect data on the activities of large banks to help calibrate a capital surcharge for systemically important banks. These data include data on interconnectedness, which will play an important role in determining the overall capital surcharge.

Q.10. Christy Romero also provided testimony about the need for large institutions to engage in effective risk management practices and for regulators to supervise this risk management.

Do you believe the risk management practices at the largest financial institutions are adequate?

A.10. In general, risk management practices and risk governance at the largest financial institutions have improved significantly since the crisis. They must constantly evolve, however, to keep pace with a complex and highly dynamic financial system. Our annual review of the capital planning processes of the largest firms provides us a regular occasion for assessing many of these practices, and, where appropriate, requiring improvements.

Q.11. Can you describe what the Department of the Treasury is doing to supervise the risk management at the largest institutions?

A.11. Risk management is a key focus of the Board's supervision of the largest bank holding companies. This is evidenced in several ways, including but not limited to:

- Risk management is one of the key criteria by which large bank holding companies are rated for supervisory purposes.
- The importance of robust risk management is highlighted throughout the recently revised guidance on consolidated supervision of large bank holding companies (SR 12-17).
- Supervisors routinely review and assess aspects and components of risk management when conducting exams, which are conducted at the largest bank holding companies on a near continual basis throughout the year.
- The qualitative assessment component of the Comprehensive Capital Assessment and Review (CCAR) focuses significantly on firms' risk management practices, including with respect to stress testing.

Of course, the Board's supervision of firms' risk management is not and cannot be a substitute for firms' own risk management practices and governance.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM DANIEL K. TARULLO

Q.1. In response to concerns that the bank-centric Basel III capital standards are unworkable for insurers, the Fed has indicated that it would perform some tailoring of those standards. However, there is continuing concern among the life insurance industry that the proposed tailoring is inadequate and does not properly acknowledge the wide differences between banking and insurance.

What kinds of more substantive changes will the Fed consider to the Basel III rulemaking to prevent negative impacts to insurers and the policyholders, savers, and retirees that are their customers?

A.1. Section 171 of the Dodd-Frank Act requires that the Federal Reserve Board (the Board) establish minimum leverage capital requirements and minimum risk-based capital requirements for depository institution holding companies and for financial companies designated by the Financial Stability Oversight Council that are not "less than" the minimum capital requirements for insured depository institutions. On June 7, 2012, the Board and the other Federal banking agencies proposed to revise their risk-based and leverage capital requirements in three notices of proposed rulemaking (NPRs), consistent with this statutory requirement.

The NPRs proposed flexibility to address the unique character of insurance companies through specific risk weights for policy loans and nonguaranteed separate accounts, which are typically held by insurance companies, but not banks. These specific risk weights were designed to apply appropriate capital treatments to assets particular to the insurance industry while complying with the requirements of section 171 of the Dodd-Frank Act.

The Board is carefully considering the comments it has received regarding the application of section 171 of the Dodd-Frank Act to savings and loan holding companies and bank holding companies that are significantly engaged in the insurance business. We will continue to consider these issues seriously, as well as the potential implementation challenges for depository institution holding companies with insurance operations, as we determine how to move forward with respect to the proposed capital requirements.

Q.2. There is also a concern that the bank standards are a dramatic departure from the duration matching framework common to insurance supervision.

What is your response to that concern and would the Fed consider doing more than just tailoring bank standards?

Do you believe that, from an insurance perspective, Basel III bank standards are an incremental or dramatic departure from current insurance standards?

A.2. As discussed in the above answer, the Board developed the proposed capital requirements to meet the requirements of the Dodd-Frank Act, to promote capital adequacy at all depository institution holding companies, and, to the extent permitted by section 171, to incorporate adjustments for depository institution holding companies significantly engaged in the insurance business. The Board has received numerous comments on the proposals with respect to insurance companies. Many of these comments discuss suggestions for other approaches to applying regulatory capital standards to depository institution holding companies that have significant insurance operations. The Board is carefully considering all of these comments.

Q.3. Regarding the Volcker Rule, some have suggested that the banking agencies should just go ahead and issue their final rule without waiting to reach agreement with the Securities and Exchange Commission and Commodities Futures Trading Commission, which have to issue their own rules. This scenario could result in there being more than one Volcker Rule, which would create significant confusion about which agency's rule would apply to which covered activity.

Do you agree that there should be only one Volcker Rule?

A.3. While section 619(b)(2) of the Dodd-Frank Act divides authority for developing and adopting regulations to implement its prohibitions and restrictions between the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, (the Agencies) based on the type of entities for which each agency is explicitly charged or is the primary financial regulatory agency, the rule proposed by the Agencies to implement section 619 contemplates that firms will develop and adopt a single, enterprise-wide compliance program and that the Agencies would strive for uniform enforcement of section 619. To enhance uniformity in both the rules that implement section 619 and administration of the requirements of section 619, the Agencies have been regularly consulting with each other in the development of rules and policies that implement section 619.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM MARTIN J. GRUENBERG

Q.1. Given how complex it is to determine whether a trade is a hedge or a proprietary trade, it appears the real issue is whether a trade threatens the safety and soundness of the bank. What benchmark does your agency use to determine whether a particular activity is or is not "hedging"? How does your agency determine whether the trade presents risks to the safety and soundness of a financial institution?

A.1. The FDIC does not have a single benchmark that it uses to determine whether a particular activity constitutes hedging as distinguished from proprietary trading. We do have certain standards that are used to determine whether activities constitute a hedge for purposes of financial reporting or, in certain instances, as an input into the bank's regulatory capital calculations. However, these standards vary based upon the purpose for which an exposure serves as a hedge. For example, in the context of financial reporting, banks use the strict hedge accounting requirements set forth by the Financial Accounting Standards Board; but, for calculating market risk capital requirements, banks can rely on their own models for determining whether an exposure provides hedging benefits. The hedging requirements in the proposed Volcker Rule are important steps forward in promoting a general standard that can be used by the banking agencies to determine whether any particular activity is legitimate hedging as opposed to proprietary trading, which introduces additional risk. While our examiners routinely review the activities of a financial institution to determine consistency with safety and soundness standards, we view the Volcker Rule as providing the FDIC with important additional tools to help determine whether an activity poses additional risk to a financial institution.

Q.2. Federal Reserve, FDIC, and OCC have issued proposed rules to implement Dodd-Frank and Basel III capital requirements for U.S. institutions. Late last year, your agencies pushed back the effective date of the proposed Basel III rules beyond January 1, 2013. Given the concerns that substantially higher capital requirements will have a negative impact on lending, are your agencies using this extra time to conduct a cost-benefit analysis about the impact of the proposed rules on the U.S. economy, availability, and cost of credit, cost of insurance, and the regulatory burden on institutions, before implementing the final rules?

A.2. In June 2012, the FDIC along with the other banking agencies approved for public comment three notices of proposed rulemaking that collectively would implement the Basel III framework, the Basel II standardized approach, and other recent enhancements to the international capital framework adopted by the Basel Committee, as well as certain provisions of the Dodd-Frank Act (the

NPRs).[1] For purposes of the NPRs, the agencies conducted the cost and burden analyses required by the Regulatory Flexibility Act, the Paperwork Reduction Act, and the Unfunded Mandates Reform Act of 1995, all of which are further detailed in the NPRs.[2] The agencies have invited public comment on these analyses.

The agencies also participated in the development of a number of studies to assess the potential impact of the revised capital requirements, including participating in the Basel Committee's Macroeconomic Assessment Group (MAG) as well as its Quantitative Impact Study, the results of which were made publicly available by the Basel Committee on Banking Supervision upon their completion.[3] Basel Committee analysis has suggested that stronger capital requirements could help reduce the likelihood of banking crises while yielding positive net economic benefits.[4] Specifically, a better capitalized banking system should be less vulnerable to banking crises, which have historically been extremely harmful to economic growth. Moreover, the MAG analysis found that the requirements would only have a modest negative impact on the gross domestic product of member countries, and that any such negative impact could be significantly mitigated by phasing in the proposed requirements over time.[5] Taken together, these studies suggest that a better capitalized banking system will better support economic growth sustainably over time.

The agencies also sought public comment on the proposed requirements in the NPRs to better understand their potential costs and benefits. The agencies asked several specific questions in the NPRs about potential costs related to the proposals and are considering all comments carefully. During the comment period, the agencies also participated in various outreach efforts, such as engaging community banking organizations and trade associations, among others, to better understand industry participants' concerns about the NPRs and to gather information on their potential effects. In addition, to facilitate public comment, the agencies developed and provided to the industry an estimation tool that would allow an institution to estimate the regulatory capital impact of the NPRs. These efforts have provided valuable additional information to assist the agencies as we determine how to proceed with the proposed rulemakings.

Q.3. Given the impact that the Qualified Mortgages (QM) rules, the proposed Qualified Residential Mortgages (QRM) rules, the Basel III risk-weights for mortgages, servicing, escrow and appraisal rules will have on the mortgage market and the housing recovery, it is crucial that these rules work in concert. What analysis has your agency conducted to assess how these rules work together? What is the aggregate impact of those three rules, as proposed and

[1] *See,* 77 *Fed. Reg.* 52792 (Aug. 30, 2012); 77 *Fed. Reg.* 52888 (Aug. 30, 2012); and 77 *Fed. Reg.* 52978 (Aug. 30, 2012).

[2] *See,* e.g., the Initial Regulatory Flexibility Analysis for the Basel III NPR, 77 *Fed. Reg.* 52792, 52833 (Aug. 30, 2012).

[3] *See,* "Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements" (MAG Analysis), also available at: *http://www.bis.org/publ/othpl2.pdf; see also,* "Results of the Comprehensive Quantitative Impact Study", also available at: *http://www.bis.org/publ/bcbsl86.pdf.*

[4] *See,* "An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements", Executive Summary, p. 1.

[5] *See,* MAG Analysis, Conclusions and open issues, pp. 9–10.

finalized, on the overall mortgage market as well as on market participants?

A.3. At the time of the release of the regulatory capital NPRs, the QM and QRM rules had not been released in final form. Accordingly, in connection with the proposed treatment for 1-4 family residential mortgage loans, the agencies solicited comment on alternative criteria or approaches for differentiating among the levels of risk inherent in different mortgage exposures. Specifically, the agencies invited comment on whether "all residential mortgage loans that meet the 'qualified mortgage' criteria to be established for purposes of the Truth in Lending Act pursuant to section 1412 of the Dodd-Frank Act [should] be included in category 1."[6] The agencies are considering the comments received in connection with the proposed treatment for 1-4 family residential mortgage exposures, as well as comments received in response to the NPR relating to Credit Risk Retention, which included proposed QRM standards.[7] Now that we have the benefit of the final QM rule, the agencies can consider QRM and Basel III in light of the QM standards. All three rules—QM, QRM, and Basel III—could impact the mortgage market. In the FDIC's view, it is important that the agencies endeavor in the final rulemaking on QRM and Basel III to take into consideration the cumulative impact of the rules on the mortgage market, including the availability of credit.

Q.4. Under the Basel III proposals mortgages will be assigned to two risk categories and several subcategories, but in their proposals the agencies did not explain how risk weights for those subcategories are determined and why they are appropriate. How did your agency determine the appropriate range for those subcategories?

A.4. The agencies currently are reviewing the numerous comment letters from banking organizations on whether the proposed methodology and risk weights for category 1 and 2 residential mortgages are appropriate. As stated in the preamble to the Standardized Approach NPR, the U.S. housing market experienced unprecedented levels of defaults and foreclosures due in part to qualitative factors such as inadequate underwriting standards, high risk mortgage products such as so-called payment-option adjustable rate mortgages, negatively amortizing loans, and the issuance of loans to borrowers with undocumented and unverified income. In addition, the agencies noted that the amount of equity a borrower has in a home is highly correlated with default risk. Therefore, the agencies proposed to assign higher risk weights to loans that have higher credit risk while assigning lower risk weights to loans with lower credit risk.

The agencies also recognize that the use of loan-to-value (LTV) ratios to assign risk weights to residential mortgage exposures is not a substitute for and does not otherwise release a banking organization from its responsibility to have prudent loan underwriting and risk management practices consistent with the size, type, and risk of its mortgage business. In deliberations on the final rule, the agencies also are reviewing the interagency supervisory guidance

[6] 77 *Fed. Reg.* 52888, 52899 (Aug. 30, 2012).
[7] 76 *Fed. Reg.* 24090 (April 29, 2011).

documents on risk management involving residential mortgages, including the Interagency Guidance on Nontraditional Mortgage Product Risks (October 4, 2006); the interagency Statement on Subprime Mortgage Lending (July 10, 2007), and the Appendix A to Subpart A of Part 365 of the FDIC Rules and Regulations–Interagency Guidelines for Real Estate Lending (December 31, 1992).

Q.5. In a speech last year you stated that the failure of a systemically important financial institution will likely have significant international operations and that this will create a number of challenges. What specific steps have been taken to improve the cross-border resolution of a SIFI? What additional steps must be taken with respect to the cross-border resolution of a SIFI?

A.5. As I stated in my testimony, the experience of the financial crisis highlighted the importance of coordinating resolution strategies across national jurisdictions. Section 210 of the Dodd-Frank Act expressly requires the FDIC to "coordinate, to the maximum extent possible" with appropriate foreign regulatory authorities in the event of the resolution of a covered financial company with cross-border operations. As we plan internally for such a resolution, the FDIC has continued to work on both multilateral and bilateral bases with our foreign counterparts in supervision and resolution. The aim is to promote cross-border cooperation and coordination associated with planning for an orderly resolution of a globally active, systemically important financial institution (G–SIFIs).

As part of our bilateral efforts, the FDIC and the Bank of England, in conjunction with the prudential regulators in our jurisdictions, have been working to develop contingency plans for the failure of G–SIFIs that have operations in both the U.S. and the U.K. Of the 28 G–SIFIs designated by the Financial Stability Board of the G20 countries, four are headquartered in the U.K., and another eight are headquartered in the U.S. Moreover, around two-thirds of the reported foreign activities of the eight U.S. SIFTs emanate from the U.K.[8] The magnitude of these financial relationships makes the U.S.–U.K. bilateral relationship by far the most important with regard to global financial stability. As a result, our two countries have a strong mutual interest in ensuring that, if such an institution should fail, it can be resolved at no cost to taxpayers and without placing the financial system at risk. An indication of the close working relationship between the FDIC and U.K. authorities is the joint paper on resolution strategies that we released in December.[9]

In addition to the close working relationship with the U.K., the FDIC and the European Commission (E.C.) have agreed to establish a joint Working Group comprised of senior staff to discuss resolution and deposit guarantee issues common to our respective jurisdictions. The Working Group will convene twice a year, once in Washington, once in Brussels, with less formal communications continuing in between. The first of these meetings will take place later this month. We expect that these meetings will enhance close

[8] Reported foreign activities encompass sum of assets, the notional value of off-balance-sheet derivatives, and other off-balance-sheet items of foreign subsidiaries and branches.

[9] "Resolving Globally Active, Systemically Important, Financial Institutions", *http://www.fdic.gov/about/srac/2012/gsifi.pdf.*

coordination on resolution related matters between the FDIC and the E.C., as well as European Union Member States.

The FDIC also has engaged with Swiss regulatory authorities on a bilateral and trilateral (including the U.K.) basis. Through these meetings, the FDIC has further developed its understanding of the Swiss resolution regime for G–SIFIs, including an in-depth examination of the two Swiss-based G–SIFIs with significant operations in the U.S. In part based on the work of the FDIC, the Swiss regulatory authorities have embraced a single point of entry approach for the Swiss based G–SIFIs.

The FDIC also has had bilateral meetings with Japanese authorities. FDIC staff attended meetings hosted by the Deposit Insurance Corporation of Japan and the FDIC hosted a meeting with representatives of the Japan Financial Services Agency to discuss our respective resolution regimes. The Government of Japan has proposed legislation to expand resolution authorities for the responsible Japanese agencies. These bilateral meetings, including an expected principal level meeting later this year, are part of our continued effort to work with Japanese authorities to develop a solid framework for coordination and information-sharing with respect to resolution, including through the identification of potential impediments to the resolution of G–SIFIs with significant operations in both jurisdictions.

These developments mark significant progress in fulfilling the mandate of section 210 of the Dodd-Frank Act and achieving the type of international coordination that would be needed to effectively resolve a G–SIFI in some future crisis situation. The FDIC is continuing efforts to engage our counterparts in other countries in greater coordination to improve the ability to achieve an orderly liquidation in the event of the failure of a large, internationally active financial institution. We will continue to pursue these efforts through both bilateral and multilateral approaches.

Q.6. In June of last year, the FDIC proposed a rule that mirrored the Federal Reserve's proposed definition of "predominantly engaged in financial activity." Since this definition triggers FDIC's ability to exercise its orderly liquidation authority, the proposed rule has generated a considerable amount of concern. Does the FDIC intend to reconsider its proposed definition of "predominately engaged in financial activities" to address concerns raised in public comment letters?

A.6. Section 201(b) of the Dodd-Frank Act requires the FDIC in consultation with the Secretary of the Treasury to establish certain definitional criteria for determining if a company is predominantly engaged in activities that the Board of Governors has determined are financial in nature or incidental thereto for purposes of section 4(k) of the Bank Holding Company Act. A company that is predominantly engaged in such activities would be considered a "financial company" for purposes of Title II of the Act.

On March 23, 2011, the FDIC published in the *Federal Register* a notice of proposed rulemaking titled "Orderly Liquidation Authority" (March 2011 NPR) that proposed, among other things, definitional criteria for determining if a company is predominantly engaged in activities that are financial in nature or incidental thereto for purposes of Title II. On June 18, 2012, the FDIC published for comment a supplemental notice of proposed rulemaking, which proposed to clarify the scope of activities that would be considered financial in nature or incidental thereto for purposes of the March 2011 NPR (June 2012 NPR).

The FDIC received eight comments responding to the March 2011 NPR and seven comments responding to the June 2012 NPR. The FDIC is currently in the process of reviewing these comments and will consider them carefully in developing its final rule.

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, DC 20429

MARTIN J. GRUENBERG
CHAIRMAN

May 29, 2013

Honorable Mike Crapo
Ranking Minority Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Crapo:

I am writing to follow up on the discussion during the February 14 Senate Banking Committee hearing on "Wall Street Reform: Oversight of Financial Stability and Consumer and Investor Protections" regarding analyses and efforts by the financial regulators to understand and quantify the anticipated cumulative effects of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) rules.

The Federal Deposit Insurance Corporation seeks to avoid imposing any unnecessary costs or burdens on the industry or the public in its rulemaking and other regulatory endeavors generally. As described in the FDIC's recently updated Statement of Policy on the Development and Review of FDIC Regulations and Policies, the FDIC gives careful consideration to the need for issuing a regulation and, once that need is determined, evaluates benefits and costs, based on available information, and considers reasonable and possible alternatives. The Statement of Policy makes clear that the main alternatives, once identified as available, should be described and analyzed for their consistency with statutory or policy objectives, effectiveness in achieving those objectives, and burden on the public or industry. As part of any notice-and-comment process, the FDIC typically seeks comment on the potential for less burdensome or more effective alternatives and carefully considers all comments, including those that focus on costs to the industry, before issuing a final rule.

The FDIC is committed to ensuring that our rulemaking and supervisory activities do not impose unnecessary costs or burdens on the banking industry or the public and that we are mindful of the effectiveness of our regulations as a whole when deliberating on new rules – whether under Dodd-Frank or otherwise.

The Government Accountability Office (GAO) has noted the difficulty of determining the comprehensive costs of Dodd-Frank rulemakings and has stated that it is too soon to assess the effects of the Dodd-Frank Act. In its January 2013 report, the GAO stated that "the Dodd-Frank Act's full impact on [financial firms'] businesses, operations, and earnings remains uncertain, in part because of the rulemakings that still need to be completed," and that "even when the reforms have been fully implemented, it may not be possible to determine precisely the extent to which observed costs can be attributed to the act versus other factors, such as changes in the economy."

In evaluating the extent to which the FDIC is considering the cumulative burden of all Dodd-Frank rulemakings on market participants and the economy, the FDIC's independent Office of Inspector General (OIG) has found that the "FDIC is working on a number of efforts to establish clear rules under the Dodd-Frank Act that will ensure financial stability while implementing those rules in a targeted manner to avoid unnecessary regulatory burden."[1] The FDIC will continue to evaluate the benefits and costs of its Dodd-Frank regulations as the entire regulatory structure is completed and its effects become more fully known and understood.

Thank you for your continued interest in this important topic. If you have further questions or comments, please do not hesitate to contact me at (202) 898-3888 or Eric Spitler, Director, Office of Legislative Affairs, at (202) 898-7140.

Sincerely,

Martin J. Gruenberg

Martin J. Gruenberg

[1] "Evaluation of the FDIC's Economic Analysis of Three Rulemakings to Implement Provisions of the Dodd-Frank Act," FDIC Office of Inspector General (June 2011): 19.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNER FROM MARTIN J. GRUENBERG

Q.1. As you know, a number of people including Sheila Bair have been advocates of using a simple leverage ratio as the primary measure of banks' capital strength. Would focusing on a simple leverage ratio, using the Basel III definition of leverage which includes key off balance sheet exposures, help cut through the noise of risk weighting and models and cross border differences, and give us all greater confidence that large banks are holding a good amount of high quality capital?

A.1. Maintaining a minimum ratio of capital to assets has been a regulatory requirement for U.S. banking organizations since the early 1980s, and a benchmark for supervisors' evaluation of capital adequacy long before that time. Leverage ratio requirements were part of the statutory framework of the Prompt Corrective Action requirements introduced in the FDIC Improvement Act of 1991.[1] Leverage ratio requirements in the United States exist side-by-side with risk-based capital requirements, and each banking organization must have sufficient capital to satisfy whichever requirement is more stringent.

Over time, as risk-based capital requirements have attempted to provide greater differentiation among types and degrees of risk, they also have become increasingly complex, particularly for advanced approaches banking organizations and those subject to the market risk rule.[2] Risk-based capital requirements for these institutions depend largely on the output of internal risk models and have been criticized for being overly complex, opaque, and difficult to supervise consistently. With only risk-based requirements, a banking organization can increase its permissible use of leverage by concentrating in exposures that receive favorable risk weights. Exposures with favorable risk weights, however, can still experience high losses.

Leverage ratio requirements, in contrast, directly constrain bank leverage and thereby offset potential weaknesses in the risk-based ratios and generate a baseline amount of capital in a way that is readily determinable and enforceable. The introduction of a leverage ratio in the international Basel III capital framework is an important step that we strongly support. It is well established that banks with higher capital as measured by the leverage ratio are less likely to fail or experience financial problems. Avoiding capital shortfalls at large institutions is particularly important in containing risks to the financial system and reducing the likelihood of economic disruption associated with problems at these institutions. It is therefore important and appropriate to have a strong leverage capital framework to complement the risk-based capital regulations. This is needed to ensure an adequate base of capital exists in the event the risk-based ratios either underestimate risk or do not inspire confidence among market participants.

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[1] Pub. L. 102-242, 105 Stat. 2236. The PCA requirements were enacted in section 38 of the Federal Deposit Insurance Act, 12 U.S.C. 1831o.

[2] Currently, the market risk capital rule is codified in 12 CFR part 325, appendix C. As of the effective date of the Basel III consolidated final rule, the citation for the market risk rule will be: 12 CFR part 324, subpart F.

Q.2. The FDIC and Fed have joint jurisdiction over the completion of living wills from large firms. Now, I don't think anyone expected the first year of plans to be perfect, but can you remind everyone, for the FDIC and Fed to approve the plans, isn't the standard that they have to show how normal liquidation like bankruptcy or FDIC resolution could work under reasonable circumstances? And what progress have the plans made in getting firms to think through their structure, better inform you as regulators, and lead to simplification and rationalization?

A.2. On July 1, 2012, the first group of living wills, generally involving bank holding companies and foreign banking organizations with $250 billion or more in nonbank assets, were received. In 2013, the firms that submitted initial plans in 2012 will be expected to refine and clarify their submissions. The Dodd-Frank Act requires that at the end of this process these plans be credible and facilitate an orderly resolution of these firms under the Bankruptcy Code. Four additional firms are expected to submit plans on July 1, 2013, and approximately 115 firms are expected to file on December 31, 2013.

Last year (2012) was the first time any firms had ever created or submitted resolution plans. There were a number of key objectives of this initial submission including:

- Identify each firm's critical operations and its strategy to maintain them in a crisis situation;
- Map critical operations and core business lines to material legal entities;
- Map cross-guarantees, service level agreements, shared employees, intellectual property, and vendor contracts across material legal entities;
- Identify and improve understanding of the resolution regimes for material legal entities;
- Identify key obstacles to rapid and orderly resolution; and
- Use plan information to aid in Title II resolution planning and to enhance ongoing firm supervision.

Each plan was reviewed for informational completeness to ensure that all regulatory requirements were addressed in the plans, and the Federal Reserve and the FDIC have been evaluating each plan's content and analysis.

Following the review of the initial resolution plans, the agencies developed instructions for the firms to detail what information should be included in their 2013 resolution plan submissions. The agencies identified an initial set of significant obstacles to rapid and orderly resolution that covered companies are expected to address in the plans, including the actions or steps the company has taken or proposes to take to remediate or otherwise mitigate each obstacle and a timeline for any proposed actions. The agencies extended the filing date to October 1, 2013, to give firms additional time to develop resolution plan submissions that address the instructions.

Resolution plans submitted in 2013 will be subject to informational completeness reviews and reviews for resolvability under the Bankruptcy Code. The agencies established a set of benchmarks for assessing a resolution under bankruptcy, including a benchmark for cross-border cooperation to minimize the risk of ring-fencing or other precipitous actions. Firms will need to provide a jurisdiction-by-jurisdiction analysis of the actions each would need to take in a resolution, as well as the actions to be taken by host authorities, including supervisory and resolution authorities. Other benchmarks expected to be addressed in the plans include: the risk of multiple, competing insolvency proceedings; the continuity of critical operations—particularly maintaining access to shared services and payment and clearing systems; the potential systemic consequences of counterparty actions; and global liquidity and funding with an emphasis on providing a detailed understanding of the firm's funding operations and cash flows.

Through this process, firms will need to think through and implement structural changes in order to meet the Dodd-Frank Act objectives of resolvability through the Bankruptcy Code.

Q.3. Are you confident that Title II can work for even the largest and most complex firms? What are the areas where we can still make improvement, and how are we progressing on improving the cross border issues?

A.3. We believe that Title II can work for even the largest and most complex firms.

The FDIC has largely completed the rulemaking necessary to carry out its systemic resolution responsibilities under Title II of the Dodd-Frank Act. In July 2011, the FDIC Board approved a final rule implementing the Title II Orderly Liquidation Authority. This rulemaking addressed, among other things, the priority of claims and the treatment of similarly situated creditors.

The FDIC now has the legal authority, technical expertise, and operational capability to resolve a failing systemic resolution. The FDIC introduced its "single entry" strategy for the resolution of a U.S. G–SIFI using the Order Liquidation Authority under Title II of the Dodd Frank Act. Since then the FDIC has been working to operationalize the strategy and enhance FDIC preparedness.

Key activities to operationalize the strategy include:

- Addressing vital issues, including valuation, recapitalization, payments, accounting, and governance, through ongoing internal FDIC projects.
- Developing and refining Title II resolution strategies that consider the specific characteristics of each of the largest U.S. domiciled SIFIs. Summaries of these plans have been shared with domestic and international regulators.
- Actively communicating this approach with key stakeholders to ensure that the market understands what actions the FDIC may take ahead of the failure to minimize irrational or unnecessarily disruptive behavior. In 2012, the FDIC participated in over 20 outreach events with academics and other thought leaders, industry groups, rating agencies, and financial market utilities in order to expand (domestic) communications/outreach efforts regarding Title II OLA.

The FDIC has made great strides in developing cooperation with host supervisors and resolution authorities in the most significant foreign jurisdictions for U.S. G–SIFIs to allow for a successful implementation of the Orderly Liquidation Authority. These dialogues with host supervisors and resolution authorities occur at both the bilateral and multilateral level.

As part of our bilateral efforts, the FDIC and the Bank of England, in conjunction with the prudential regulators in our respective jurisdictions, have been working to develop contingency plans for the failure of G–SIFIs that have operations in both the U.S. and the U.K. Approximately 70 percent of the reported foreign activities of the eight U.S. G–SIFIs emanates from the U.K. An indication of the close working relationship between the FDIC and U.K. authorities is the joint paper on resolution strategies that the FDIC and the Bank of England released in December 2012. This joint paper focuses on the application of "top-down" resolution strategies for a U.S. or a U.K. financial group in a cross-border context and addressed several common considerations to these resolution strategies.

In addition to the close working relationship with the U.K., the FDIC and the European Commission (E.C.) have agreed to establish a joint Working Group comprised of senior staff to discuss resolution and deposit guarantee issues common to our respective jurisdictions. The Working Group will convene twice a year, once in Washington, once in Brussels, with less formal communications continuing in between. The first of these meetings will take place later this month. We expect that these meetings will enhance close coordination on resolution related matters between the FDIC and the E.C., as well as European Union Member States.

The FDIC also has engaged with Swiss regulatory authorities on a bilateral and trilateral (including the U.K.) basis. Through these meetings, the FDIC has further developed its understanding of the Swiss resolution regime for G–SIFIs, including an in-depth examination of the two Swiss-based G–SIFIs with significant operations in the U.S. In part based on the work of the FDIC, the Swiss regulatory authorities have embraced a single point of entry approach for the Swiss based U-SIFIs.

The FDIC also has had bilateral meetings with Japanese authorities. FDIC staff attended meetings hosted by the Deposit Insurance Corporation of Japan and the FDIC hosted a meeting with representatives of the Japan Financial Services Agency, to discuss our respective resolution regimes. The Government of Japan has proposed legislation to expand resolution authorities for the responsible Japanese Agencies. These bilateral meetings, including an expected principal level meeting later this year, are part of our continued effort to work with Japanese authorities to develop a solid framework for coordination and information-sharing with respect to resolution, including through the identification of potential impediments to the resolution of G–SIFIs with significant operations in both jurisdictions.

Q.4. The statutory language for funds defined under the Volcker Rule pointedly did not include venture funds, however the definition in the proposed rule seemed to indicate that venture funds would be covered. In addition to exceeding the statutory intent of Congress, this has created uncertainty in the market as firms await a final rule and refrain from making commitments which might be swept up in the final version of the Volcker Rule. Can you clarify whether venture funds are covered by the Volcker Rule?

A.4. Section 619(h)(2) of the Dodd-Frank Act defines the terms "hedge fund" and "private equity fund" as "an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1, et seq.), but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine." This definition, as written, would cover the majority of venture capital funds.

As part of the NPR, the agencies sought public comment on whether venture capital funds should be excluded from the definition of "hedge fund" and "private equity fund" for purposes of the Volcker Rule. In the NPR, the agencies asked:

> Should venture capital funds be excluded from the definition of "covered fund"? Why or why not? If so, should the definition contained in rule 203(l)-(1) under the [Investment] Advisers Act be used? Should any modifications to that definition of venture capital fund be made? How would permitting a banking entity to invest in such a fund meet the standards contained in section 13(d)(1)(J) of the [Bank Holding Company Act]?

In conjunction with the development of the final rule, the agencies are reviewing public comments responding to the NPR, including comments on this question related to venture capital funds. The agencies will give careful consideration to these comments in the development of the final rule.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR HEITKAMP FROM MARTIN J. GRUENBERG

Q.1. Chairman Gruenberg, I thank you for understanding that as relationship lenders in local communities, community banks are able to provide much needed financing to both residential and commercial borrowers in rural and underserved areas where larger banks are unable or unwilling to participate. Have you thoroughly considered the impact of higher risk weights from Basel III on community banks, as well as on the local communities where they serve?

A.1. The FDIC recognizes the important role that community banks play in the financial system, which includes providing credit to small businesses and homeowners throughout the country. During the comment period, the agencies participated in various outreach efforts, such as engaging community banking organizations and trade associations, among others, to better understand industry participants' concerns about the proposed revisions to the general risk-based capital rules and to gather information on their potential effects. To facilitate comment on the NPRs, the agencies developed and provided to the industry an estimation tool that would allow an institution to estimate the regulatory capital impact of the proposals. The FDIC conducted roundtables in each of our regional offices and hosted a nationwide Web cast to explain the components of the rules and answer banker questions. Lastly we developed instructional videos on the two rulemakings applicable to community banks. These videos received more than 7,000 full views in the first 3 months of availability. We believe these efforts contributed to the more than 2,500 comments we received, which have provided valuable additional information to assist the agencies as we determine how to proceed with the NPRs. Particular attention is being given to the comments on the impact of the proposed rules on community banks.

Q.2. Chairman Gruenberg, first, I'd like to thank you and the FDIC for making the community bank industry a priority for your agency. After conducting your study and hosting regional roundtables, what were the most significant problems you found on the ground? What did your agency do to address them?

A.2. Community banks play a critical role in the national and local economies by extending credit to consumers and businesses. As you indicate, the FDIC has launched several initiatives to further the understanding of how community banks have evolved during the past 25 years, current opportunities and challenges facing community bankers, and what lies ahead. The FDIC launched the Community Banking Initiative in February 2012 with a national conference on community banking. Roundtable discussions were then held in the FDIC's six regions, and the FDIC Community Banking Study was released in December 2012. We also conducted comprehensive reviews of our examination and rulemaking processes. Overall, the findings from these initiatives indicate the community banking model remains viable and that community banks will be an important part of the financial landscape for years to come. The findings also identified financial and operational challenges facing community banks as well as opportunities for the FDIC to strengthen the efficiency and effectiveness of its examination and rulemaking processes.

The FDIC Community Banking Study is a data-driven effort to identify and explore community bank issues. The first chapter develops a research definition for the community bank that is used throughout the study. Subsequent chapters address structural change, the geography of community banking, comparative financial performance, community bank balance sheet strategies, and capital formation at community banks. This study is intended to be a platform for future research and analysis by the FDIC and other interested parties.

Community bankers identified a number of financial challenges during the roundtable discussions, especially that there is an insufficient volume of quality loans available in many markets. They also stated that capital raises are increasingly difficult in the current banking environment and the low-rate environment is leading to a build-up of interest rate risk. Community bankers also expressed concern about the ability to retain quality staff and how to satisfy customers' demands for greater availability of mobile banking technologies. Although the vast majority of banker comments regarding their experience with the examination process were favorable, a general perception exists that new regulations and heightened scrutiny of existing regulations are adding to the cost of doing business. Community bankers also note there are opportunities to enhance communication with examination staff and expand and strengthen technical assistance provided by the FDIC.

The FDIC has undertaken initiatives to address comments received from bankers during the roundtable discussions. To enhance our examination processes, the FDIC developed a tool that generates pre-examination request documents tailored to a bank's specific operations and business lines. The FDIC is improving how information is shared electronically between bankers and examiners through its secure Internet channel, FDICconnect, which will ensure better access for bankers and examiners. We also revised the classification system for citing violations identified during compliance examinations to better communicate to institutions the severity of violations and to provide more consistency in the classification of violations cited in Reports of Examination.

The FDIC also issued a Financial Institution Letter, entitled "Reminder on FDIC Examination Findings" (FIL-13-2011 dated March 1, 2011), encouraging banks to provide feedback about the supervisory process. Since then, we continue to conduct outreach sessions and hold training workshops and symposiums, and have created the Director's Resource Center Web page to enhance technical assistance provided to bankers on a range of bank regulatory issues. Also, the FDIC has developed and posted a Regulatory Calendar on *www.fdic.gov* to keep bankers current on the issuance of rules, regulations, and guidance; and we are holding industry calls to communicate critical information to bankers about pending regulatory changes.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM MARTIN J. GRUENBERG

Q.1. In response to concerns that the bank-centric Basel III capital standards are unworkable for insurers, the Fed has indicated that it would perform some tailoring of those standards. However, there is continuing concern among the life insurance industry that the proposed tailoring is inadequate and does not properly acknowledge the wide differences between banking and insurance.

What kinds of more substantive changes will the Fed consider to the Basel III rulemaking to prevent negative impacts to insurers and the policyholders, savers, and retirees that are their customers?

There is also a concern that the bank standards are a dramatic departure from the duration matching framework common to insurance supervision.

What is your response to that concern and would the Fed consider doing more than just tailoring bank standards?

Do you believe that, from an insurance perspective, Basel III bank standards are an incremental or dramatic departure from current insurance standards?

A.1. Section 171 of the Dodd-Frank Act requires the establishment of minimum consolidated leverage and risk-based capital requirements for savings and loan holding companies, a number of which have significant insurance activities. The FDIC recognizes the distinctions between banking and insurance and the authorities given to the States. In 2011, we amended our general risk-based capital requirements to provide flexibility in addressing consolidated capital requirements for low-risk nonbank activities, including certain insurance-related activities. We will continue to bear in mind these distinctions as we work with our fellow regulators to ensure that the final rule provides for an adequate transition period that is consistent with Section 171.

Q.2. Regarding the Volcker Rule, some have suggested that the banking agencies should just go ahead and issue their final rule without waiting to reach agreement with the Securities and Exchange Commission and Commodities Futures Trading Commission, which have to issue their own rules. This scenario could result in there being more than one Volcker Rule, which would create significant confusion about which agency's rule would apply to which covered activity. Do you agree that there should be only one Volcker Rule?

A.2. All entities affected by the Volcker Rule should be operating under similar requirements. Section 619(b)(2) of the Dodd-Frank Act contains specific coordinated rulemaking requirements that serve to help clarify the application of individual agency rules, to ensure that agency regulations are comparable, and to require coordination and consistency in the application of the Volcker Rule. To that end, the Federal banking agencies, the SEC, and the CFTC are currently working together in the process of developing a final Volcker Rule.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM THOMAS J. CURRY

Q.1. Given how complex it is to determine whether a trade is a hedge or a proprietary trade, it appears the real issue is whether a trade threatens the safety and soundness of the bank. What benchmark does your agency use to determine whether a particular activity is or is not "hedging"? How does your agency determine whether the trade presents risks to the safety and soundness of a financial institution?

A.1. Our agency evaluates whether particular activities are hedging based on their effectiveness in managing risks arising from banking activities and their conformance with the bank's hedging policies and procedures. OCC Banking Circular 277 discusses appropriate risk management of financial derivatives.

The OCC expects banks to establish hedging policies and procedures that clearly specify risk appetite, hedging strategies, including the types of hedge instruments permitted, and to document hedge positions. Documentation should include identification of the assets or liabilities or positions being hedged, how the hedge manages the risk associated with those assets or liabilities or positions, and how and when the hedge will be tested for effectiveness. As an additional control, a bank's risk management systems should facilitate stress testing and enable management and the OCC to assess the potential impact of various changes in market factors on earnings and capital. We also expect banks to establish prudent limits and sub-limits on hedging instruments to protect against concentrations in any particular instruments.

We expect banks to produce periodic risk, as well as hedging profit and loss (P&L) reports, and we use those reports to identify hedging activities that show an increase in risks and produce material amounts of continuing profits or losses and may warrant further review. As with any other significant positions on or off-balance sheet, the institution's internal risk management function should review material hedged positions, resulting material profits or losses, and material risk measures (e.g., stress, value-at-risk, and relevant nonstatistical risk measures) to evaluate whether activities are effectively mitigating risk and whether the hedging activities present risks to the safety and soundness of the bank.

The OCC recognizes that controls at smaller banks with simpler hedging activity need not be as complex and sophisticated as at larger banks. Nevertheless, at a minimum, these banks' risk management systems should evaluate the possible impact of hedges on earnings and capital that may result from adverse changes in interest rates and other relevant market conditions. We expect these banks to periodically review the effectiveness of their hedges as a part of the bank's overall risk management; including, where appropriate, back testing. In addition, examiners review large holdings in the investment and derivatives portfolios, as well as material changes that have occurred between examinations.

We also note that the Volcker Rule provisions of the Dodd-Frank Act prohibit proprietary trading except for certain permitted activities, including risk-mitigating hedging. The proposed implementing regulations issued by the agencies, including the OCC, contain a number of requirements designed to ensure that a banking entity's hedging activities reduce specific risks in connection with the entity's individual or aggregate holdings and do not give rise to new exposures that are not simultaneously hedged. For example, the proposed regulations require banking entities to engage in permitted hedging activities in accordance with written policies and procedures, subject to continuing review, monitoring and management, and only if compensation arrangements of persons performing hedging activities are designed not to reward proprietary risk-taking. The interagency Volcker regulations, when finalized, will provide standards for distinguishing a hedge from a proprietary trade, in addition to the supervisory standards described above.

Q.2. Federal Reserve, FDIC, and OCC have issued proposed rules to implement Dodd-Frank and Basel III capital requirements for U.S. institutions. Late last year, your agencies pushed back the effective date of the proposed Basel III rules beyond January 1, 2013. Given the concerns that substantially higher capital requirements will have a negative impact on lending, are your agencies using this extra time to conduct a cost-benefit analysis about the impact of the proposed rules on the U.S. economy, availability, and cost of credit, cost of insurance, and the regulatory burden on institutions, before implementing the final rules?

A.2. In response to the three notices of proposed rulemaking, the Federal banking agencies received more than 4,000 total comments, many of which expressed concern about the potential impact of the rulemaking on U.S. banking organizations and, in particular, their ability to serve as financial intermediaries. Late last year, the ace and the other Federal banking agencies determined that, rather than rushing to implement a final rule, it would be prudent to delay the final rulemaking in order to review all the comments carefully and ensure that the final rulemaking appropriately addresses the commenters' concerns without sacrificing the goal of implementing substantial improvements to the agencies' respective regulatory capital frameworks. The agencies now are working to complete the final rule and to update and revise their analyses, as appropriate.

For the proposals, the OCC conducted those cost and burden analyses required by the Regulatory Flexibility Act, the Paperwork Reduction Act, and the Unfunded Mandates Reform Act of 1995, among others, the results of which were detailed in the proposals. For the final rulemaking, the OCC and the other Federal banking agencies are working to update those analyses. Additionally, the agencies must determine whether the rule is likely to be a "major rule" for the purposes of the Congressional Review Act, which is defined, in part, as any rule that results in or is likely to result in an annual effect on the economy of $100 million or more.

In response to several specific questions in the proposals about potential costs related to the proposals, a substantial number of commenters provided a great deal of feedback both on the potential impact of specific provisions, and on the proposed framework in its entirety. During the comment period, the agencies also participated in various outreach efforts, such as engaging community banking organizations and trade associations, among others, to better understand industry participants' concerns about the proposals and to gather information on their potential effects. These efforts have provided valuable additional information that the OCC and the other Federal banking agencies are considering as we develop the final rule and analyze its potential impact.

The CCC continues to believe that all banking organizations need a strong capital base to enable them to withstand periods of economic adversity and continue to fulfill their role as a source of credit to the economy. Therefore, the CCC is working diligently with the other Federal banking agencies to complete the rulemaking process and develop a final rule as expeditiously as possible.

Q.3. Given the impact that the Qualified Mortgages (QM) rules, the proposed Qualified Residential Mortgages (QRM) rules, the Basel III risk-weights for mortgages, servicing, escrow, and appraisal rules will have on the mortgage market and the housing recovery, it is crucial that these rules work in concert. What analysis has your agency conducted to assess how these rules work together? What is the aggregate impact of those three rules, as proposed and finalized, on the overall mortgage market as well as on market participants?

A.3. This body of rules, covering securitization risk retention, risk-based capital, and consumer protection in the origination and servicing of mortgages, are all part of the Government's response to fundamentally unsound mortgage market practices that were the eventual triggering mechanism for the financial crisis. They address different aspects of the interlinked market mechanisms through which mortgages are created, funded, and administered. Several agencies are involved in fashioning these rules, including the banking agencies and the CFPB, the SEC, the FHFA, and HUD.

The OCC has not been part of the rulemaking group for all these rules, but it has been involved in the rulemakings for securitization risk retention, Basel III, and appraisals for higher-risk mortgages. For each of these regulatory proposals, the OCC and the other agencies participating in the rulemakings have designed the proposed rules to impose new market protections in a fashion that appropriately preserves the availability of mortgages to creditworthy consumers at reasonable prices. In addition, the OCC conducted cost and burden analyses of the impact of the proposed rules on mortgage market participants that will be subject to the new rules, as required by the Regulatory Flexibility Act, the Paperwork Reduction Act, and the Unfunded Mandates Reform Act of 1995. For the final rulemaking, the OCC must determine whether the rule is likely to be a "major rule" for the purposes of the Congressional Review Act, which is defined, in part, as any rule that results in or is likely to result in an annual effect on the economy of $100 million or more.

In addition, in response to the agencies' request for public comments on these proposed rules, commenters have expressed concern to the agencies about the potential impact on mortgage availability and prices, and in certain instances provided quantitative analysis to support their views. We are considering these views and information as we go forward with the rulemakings.

Q.4. Under the Basel III proposals mortgages will be assigned to two risk categories and several subcategories, but in their proposals the agencies did not explain how risk weights for those subcategories are determined and why they are appropriate. How did your agency determine the appropriate range for those subcategories?

A.4. An overarching concern from the many comment letters the agencies received was the proposed treatment of residential mortgages in the Standardized Approach NPR. As stated in the proposal, residential mortgages would be separated into two risk categories based on product and underwriting characteristics and then, within each category, assigned risk weights based on loan-to-value ratios (LTVs).

During the market turmoil, the U.S. housing market experienced significant deterioration and unprecedented levels of mortgage loan defaults and home foreclosures. The causes for the significant increase in loan defaults and home foreclosures included inadequate underwriting standards, the proliferation of high-risk mortgage products, the practice of issuing mortgage loans to borrowers with undocumented income, as well as a precipitous decline in housing prices and a rise in unemployment.

The NPR proposed to increase the risk sensitivity of the regulatory capital rules by raising the capital requirements for the riskiest, nontraditional mortgages while actually lowering the requirements for relatively safer, traditional residential mortgage loans with low LTVs. These provisions in the Standardized Approach NPR were designed to address some of the causes of the crisis attributed to mortgages as well as to provide greater risk sensitivity in banks, capital requirements.

Given the characteristics of the U.S. residential mortgage market, the agencies believed that a wider range of risk weights based on key risk factors including product and underwriting characteristics and LTVs were more appropriate. The proposed ranges and key risk factors were developed on an interagency basis with the expert supervisory input of policy experts and bank examiners.

The OCC recognizes that some aspects of the proposed treatment for residential mortgages could impose a burden on community banks and thrifts. We are considering all the issues raised by the commenters as we develop the final rule in conjunction with the other banking agencies.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM THOMAS J. CURRY

Q.1. Can you provide a list of OCC consent orders with the top five national banks by asset size over the past 20 years?

A.1. Attached is a list of the top five national banks by asset size over a 20-year period [*OCC Large Banks*] as well as a list that contains all public formal enforcement actions against those banks [*Selected OCC Enforcement Actions Against Large Banks*].

Q.2. Can you also describe the process by which OCC tracks consent orders and verifies bank compliance with the terms?

A.2. Large Bank Supervision (LBS) teams provide ongoing supervisory oversight to ensure banks comply with Consent Orders and implement timely corrective action. They enter Consent Orders into LBS information systems. This includes LB–ID, which provides a high level record of the outstanding Consent Order. The enforcement document is housed in WISDM, which contains all documents of record for a particular institution. WISDM allows the examination team to create folders that contain the full document and bank responses, correspondence, and supporting information for each Article. Examination teams may also use official OCC shared sites (e.g., Sharepoint) as a working repository in conjunction with WISDM. Teams monitor compliance with each article of the Consent Order through regular discussions with bank management and internal audit, and confirm compliance through testing during the ongoing supervisory process and/or targeted reviews. The examiner-in-charge may assign individual examiners reporting through the team lead the responsibility for tracking and follow-up on particular Articles.

LBS teams formally communicate the status of corrective actions and compliance with Articles in the Consent Order through Supervisory Letters. An LBS team generally requires the bank's internal audit to test for compliance and correction of the identified weakness before the OCC will render judgment of the adequacy of the actions. LBS teams utilize the internal audit's findings and recommendations and also perform testing and sampling to ensure proper remediation and sustainability of corrective actions. If satisfactory, the examiner will provide documentation to the examiner-in-charge to support a decision on compliance.

Midsize and Community Bank Supervision (MCBS) examination teams continuously track Consent Order compliance through on-site examinations; off-site monitoring, and regular correspondence with banks. They maintain a detailed inventory of the individual actionable Articles within each Consent Order under a designated file structure on Examiner View (EV). EV allows examiners to identify and track due dates for each Article, the documentation the bank provides in response to each requirement, the examiners' notes on the bank's progress in achieving compliance, and ultimately whether the bank has achieved compliance. EV also ties each Article in an enforcement document to the relevant Matter Requiring Attention. if applicable. Because each Article has different requirements for the bank to submit information, EV also includes an inventoried location for storing all enforcement action related follow-up documentation.

MCBS teams use EV to establish the supervisory strategy and develop examination resource requirements for each FDICIA cycle. Each full scope and interim examination will include an assessment and detailed description of enforcement action compliance. Occasionally, MCBS teams will conduct other targeted reviews or off-site reviews that focus on a discrete area of the enforcement action to supplement the supervisory cycle. Generally, MCBS teams communicate their conclusions regarding Consent Order compliance to the bank twice a year within examination reports; however, they often will send Supervisory Letters in response to individual bank submissions.

Q.3. Has the OCC conducted any internal research or analysis on trade-offs to the public between settling an enforcement action without admission of guilt and going forward with litigation as necessary to obtain such admission?

If so, can you provide that analysis to the Committee?

A.3. The OCC does not have any internal research or analysis on the trade-offs of settling without an admission of liability.

SELECTED OCC ENFORCEMENT ACTIONS AGAINST LARGE BANKS

BANK NAME	ENF ACTN NUMBER	ENF ACTN TYPE	ENF ACTN EFFECTIVE DT	ENF ACTN CMP OR RESTITUTN AMT
Bank of America, NA	974	Bank civil money penalty	1/15/1992	$ 100,000
Bank of America, NA	974	Securities enforcement	1/15/1992	
Bank of America, NA	2005-10	Formal agreement	2/9/2005	
Bank of America, NA	2010-239	Formal agreement	12/7/2010	$ 9,217,218
Bank of America, NA	2011-048	Cease and desist	4/13/2011	
Bank of America, NA	2012-039	Formal agreement	2/27/2012	
Bank of America, NA	2013-127	Cease and desist	2/28/2013	
Citibank, NA	634	Securities enforcement	6/24/1992	
Citibank, NA	2003-77	Formal agreement	7/28/2003	
Citibank, NA	2011-046	Cease and desist	4/13/2011	
Citibank, NA	2012-041	Formal agreement	2/24/2012	
Citibank, NA	2012-052	Cease and desist	4/5/2012	
Citibank, NA	2013-131	Cease and desist	2/28/2013	
The Chase Manhattan Bank (NA)	94-158	Securities enforcement	10/5/1994	
JPMorgan Chase Bank, NA	2011-050	Cease and desist	4/13/2011	
JPMorgan Chase Bank, NA	2011-094	Bank civil money penalty	6/14/2011	$ 2,000,000
JPMorgan Chase Bank, NA	2011-105	Bank civil money penalty	7/6/2011	$ 22,000,000
JPMorgan Chase Bank, NA	2011-108	Formal agreement	7/6/2011	$ 13,051,527
JPMorgan Chase Bank, NA	2012-040	Formal agreement	2/22/2012	
JPMorgan Chase Bank, NA	2013-001	Cease and desist	1/14/2013	
JPMorgan Chase Bank, NA	2013-002	Cease and desist	1/14/2013	
JPMorgan Chase Bank, NA	2013-129	Cease and desist	2/28/2013	
U.S. Bank NA	2006-127	Bank civil money penalty	10/18/2006	$ 125,000
U.S. Bank NA	2011-049	Cease and desist	4/13/2011	
U.S. Bank NA	2013-128	Cease and desist	2/28/2013	
Wachovia Bank, NA	2008-027	Bank civil money penalty	4/24/2008	$ 10,000,000
Wachovia Bank, NA	2008-028	Formal agreement	4/24/2008	$ 125,000,000
Wachovia Bank, NA	2008-159	Formal agreement	12/8/2008	
Wachovia Bank, NA	2009-063	Bank civil money penalty	5/8/2009	$ 51,205
Wachovia Bank, NA	2010-036	Bank civil money penalty	3/12/2010	$ 50,000,000
Wachovia Bank, NA	2010-037	Cease and desist	3/12/2010	
Wells Fargo Bank, NA	2005-77	Bank civil money penalty	6/27/2005	$ 115,000
Wells Fargo Bank, NA	2011-051	Cease and desist	4/13/2011	
Wells Fargo Bank, NA	2011-175	Bank civil money penalty	12/8/2011	$ 20,000,000
Wells Fargo Bank, NA	2011-174	Formal agreement	12/8/2011	$ 14,518,013
Wells Fargo Bank, NA	2012-042	Formal agreement	2/22/2012	
Wells Fargo Bank, NA	2013-132	Cease and desist	2/28/2013	

OCC Large Banks

Years (YE Total Assets)	Five Largest Financial Institutions	Charter Number
2012-2010	• JP Morgan Chase Bank, National Assoc., Columbus, OH • Bank of America, National Assoc., Charlotte, NC • Citibank, National Association, Sioux Falls, SD • Wells Fargo Bank, National Association, Sioux Falls, SD • U.S. Bank National Association, Cincinnati, OH	• 8 • 13044 • 1461 • 1 • 24
2009-2002	• JP Morgan Chase Bank, National Assoc., Columbus, OH • Bank of America, National Assoc., Charlotte, NC • Citibank, National Association, Sioux Falls, SD • Wells Fargo Bank, National Association, Sioux Falls, SD • Wachovia Bank, National Association, Charlotte, NC	• 8 • 13044 • 1461 • 1 • 1
2001-2000	• JP Morgan Chase Bank, National Assoc., Columbus, OH • Bank of America, National Assoc., Charlotte, NC • Citibank, National Association, Sioux Falls, SD • Wachovia Bank, National Association, Charlotte, NC • Fleet National Bank, Providence, RI	• 8 • 13044 • 1461 • 1 • 200
1999	• JP Morgan Chase Bank, National Assoc., Columbus, OH • Bank of America, National Assoc., Charlotte, NC • Citibank, National Association, Sioux Falls, SD • Wells Fargo Bank, National Association, Sioux Falls, SD • Wachovia Bank, National Association, Charlotte, NC	• 8 • 13044 • 1461 • 1 • 1
1998	• JP Morgan Chase Bank, National Assoc., Columbus, OH • Bank of America, National Assoc., Charlotte, NC • Citibank, National Association, Sioux Falls, SD • Wachovia Bank, National Association, Charlotte, NC • Bank of America, National Association, Charlotte, NC	• 8 • 13044 • 1461 • 1 • 14448
1997	• JP Morgan Chase Bank, National Assoc., Columbus, OH • Bank of America, National Assoc., Charlotte, NC • Citibank, National Association, Sioux Falls, SD • Bank of America, National Association, Charlotte, NC • First Union National Bank, Charlotte, NC	• 8 • 13044 • 1461 • 14448 • 15650
1996	• JP Morgan Chase Bank, National Assoc., Columbus, OH • Bank of America, National Assoc., Charlotte, NC • Citibank, National Association, Sioux Falls, SD • Wells Fargo Bank, National Association, Sioux Falls, SD • Bank of America, National Association, Charlotte, NC	• 8 • 13044 • 1461 • 1 • 14448
1995	• JP Morgan Chase Bank, National Assoc., Columbus, OH • Bank of America, National Assoc., Charlotte, NC • Citibank, National Association, Sioux Falls, SD • Bank of America, National Association, Charlotte, NC • The Chase Manhattan bank (National Association), NY,NY	• 8 • 13044 • 1461 • 14448 • 2370
1994-1992	• JP Morgan Chase Bank, National Assoc., Columbus, OH • Bank of America, National Assoc., Charlotte, NC • Citibank, National Association, Sioux Falls, SD • Wells Fargo Bank, National Association, Sioux Falls, SD • The Chase Manhattan Bank (National Association), NY, NY	• 8 • 13044 • 1461 • 1 • 2370

OCC Large Banks

Notes:

- Cht # 8, JP Morgan Chase Bank, NA; Ch#13044 Bank of America, NA; and Cht #1461 Citibank NA==in top five 1992- 2012
- 2000 The Chase Manhattan Bank merged with JPMorgan
- 2008 1[st] Union Purchased Wachovia; Wachovia name maintained
- 2008 Wells Fargo Bank purchased Wachovia Bank
- 2009 Bank of America purchased Fleet National Bank

RESPONSES TO WRITTEN QUESTIONS OF SENATOR HEITKAMP FROM THOMAS J. CURRY

Q.1. Comptroller Curry, I thank you for understanding that as relationship lenders in local communities, community banks are able to provide much needed financing to both residential and commercial borrowers in rural and underserved areas where larger banks are unable or unwilling to participate. Have you thoroughly considered the impact of higher risk weights from Basel III on community banks, as well as on the local communities where they serve?

A.1. The OCC is very much aware of the special role that smaller banks play in our communities in providing financing of our country's small businesses and families. Given the vital role that banks serve in our national economy and local communities, we are committed to helping ensure that the business model of banks, both large and small, remains vibrant and viable.

As noted in the preambles to the proposals, the agencies assessed the potential effects of the proposed rules on banks by using regulatory reporting data and making certain key assumptions. The agencies' assessments indicated that most community banks hold capital well above both the existing and the proposed regulatory minimums. Therefore, the proposed requirements are not expected to impact significantly the capital structure of most banks.

One of the key purposes of the notice and comment process is to gain a better understanding of the potential impact of a proposal on banks of all sizes. To foster feedback from community banks on potential effects of the proposals, the agencies developed and posted on their respective Web sites an estimator tool that allowed a smaller bank to use bank-specific information to assess the likely impact on the individual institution.

The OCC remains committed to reviewing and evaluating the issues and the comments received as we move toward a final rule.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM THOMAS J. CURRY

Q.1. In response to concerns that the bank-centric Basel III capital standards are unworkable for insurers, the Fed has indicated that it would perform some tailoring of those standards. However, there is continuing concern among the life insurance industry that the proposed tailoring is inadequate and does not properly acknowledge the wide differences between banking and insurance.

What kinds of more substantive changes will the Fed consider to the Basel III rulemaking to prevent negative impacts to insurers and the policyholders, savers, and retirees that are their customers?

A.1. The Federal Reserve Board is the primary regulator of bank and savings and loan holding companies (SLHCs), including SLHCs that have insurance companies in their corporate structures. We therefore defer to the Federal Reserve Board to respond to this question.

Q.2. There is also a concern that the bank standards are a dramatic departure from the duration matching framework common to insurance supervision.

What is your response to that concern and would the Fed consider doing more than just tailoring bank standards?

Do you believe that, from an insurance perspective, Basel III bank standards are an incremental or dramatic departure from current insurance standards?

A.2. We defer to the Federal Reserve Board to respond to these questions.

Q.3. Regarding the Volcker Rule, some have suggested that the banking agencies should just go ahead and issue their final rule without waiting to reach agreement with the Securities and Exchange Commission and Commodities Futures Trading Commission, which have to issue their own rules. This scenario could result in there being more than one Volcker Rule, which would create significant confusion about which agency's rule would apply to which covered activity.

Do you agree that there should be only one Volcker Rule?

A.3. The Dodd-Frank Act envisions a coordinated effort among the Volcker Rule rulewriting agencies. It requires the Federal banking agencies to issue a joint regulation; it further requires the banking agencies and the Securities and Exchange Commission and Commodity Futures Trading Commission to consult and coordinate with one another for the purpose of assuring that their rules are comparable and provide for consistent application. The agencies have been regularly consulting with each other and will continue to do so to achieve the consistency that Congress clearly intended.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNER FROM RICHARD CORDRAY

Q.1. I am concerned that in Virginia we have a number of low-density areas that may not qualify for the rural or underserved category within Qualified Mortgages based on their Urban Influence Codes, lenders' volume, or other reasons. However, these areas may still have high-acreage properties and nonstandard loans that will have a hard time refinancing in the short-term and finding new originators in the long-term. Can you address these concerns, describe why the CFPB chose to use UICs, and respond to whether the Bureau would consider using borrower profiles in addition to geographical classifications?

A.1. The Bureau followed the structure of the Federal Reserve Board's proposal to use a county-based metric based on the Department of Agriculture's "urban influence codes" which place every county in the United States into a category based upon size and proximity to a metropolitan or micropolitan area. This county-based definition was chosen in part because implementing it should be fairly straightforward; by contrast, we received some input indicating that definitions that split counties to isolate rural areas can create greater compliance burdens for small banks. The Bureau has expanded the list of eligible codes to include counties in which about 9 percent of the Nation's population lives, up from about 3 percent as originally proposed. We expect that the vast majority of community banks and credit unions operating predominantly in those areas meet the definition of small creditor—approximately 2,700 institutions in total.

The Bureau wants to preserve access to credit for small creditors operating responsibly in rural and underserved areas. So under the Ability-to-Repay rule, we extended Qualified Mortgage status to certain balloon loans held in portfolio by small creditors operating predominantly in rural or underserved areas. We also proposed amendments to the Ability-to-Repay rule to accommodate mortgage lending by smaller institutions, including those operating outside of what are designated as rural and underserved areas. Our proposal would treat loans made by smaller lenders and held in portfolio at certain small institutions as Qualified Mortgages even if the loans exceed 43 percent debt-to-income ratio, as long as the lender considered debt-to-income or residual income before making the loan, and as long as the loans meet the product feature and other requirements for Qualified Mortgages. This proposed exemption would cover institutions that hold less than $2 billion in assets and, with affiliates, extend 500 or fewer first lien mortgages per year. The Bureau estimates that approximately 9,200 community banks and credit unions would be affected by the proposed exemption. Under the proposal, these portfolio loans made by small creditors that are Qualified Mortgages would have a safe harbor from Ability-to-Repay liability if the interest rate is within 3.5 percent over the average prime offer rate. The Bureau also proposed to extend the same increase in the safe harbor threshold for Qualified Mortgage balloon loans made by small institutions predominantly serving rural and underserved areas. The comment period for our proposal recently ended, and we are now assessing the comments we received before finalizing this measure.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR HEITKAMP FROM RICHARD CORDRAY

Q.1. Director Cordray, as the President stated in the State of the Union address, overlapping regulations of our mortgage markets have the potential to constrain credit and cause otherwise worthy borrowers from qualifying for mortgages. I'm especially concerned about the impact that these new rules will have on smaller institutions that serve States like North Dakota. What will the Bureau be doing to ensure those institutions have clear, written guidance to clarify these new regulations and to make sure lenders have the time to comply with them?

A.1. The Bureau recognizes that the model of relationship lending and customer service for which small lenders such as community banks and credit unions are known was not a driver of the excesses in the mortgage market leading up to the financial crisis. And we want to preserve access to credit for small creditors operating responsibly in rural and underserved areas. So under the Ability-to-Repay rule, we extended Qualified Mortgage status to certain balloon loans held in portfolio by small creditors operating predominantly in rural or underserved areas.

The Bureau also proposed amendments to the Ability-to-Repay rule to accommodate mortgage lending by smaller institutions—particularly for portfolio loans made by small lenders—including those operating outside of what are designated as rural or underserved areas. Our proposal would treat these as Qualified Mortgages even if the loans exceed 43 percent debt-to-income ratio, as long as the lender considered debt-to-income or residual income before making the loan, and as long as the loans meet the product feature and other requirements for Qualified Mortgages. This proposed exemption would cover institutions that hold less than $2 billion in assets and, with affiliates, extend 500 or fewer first lien mortgages per year. The Bureau estimates that approximately 9,200 community banks and credit unions would be affected by the proposed exemption. Under the proposal, loans made by small creditors that are Qualified Mortgages would have a safe harbor from Ability-to-Repay liability if the interest rate is within 3.5 percent over the average prime offer rate. The comment period for our proposal recently ended, and we are now assessing the comments we received before finalizing this measure.

In addition, our escrow rule includes an exemption for small creditors in rural or underserved areas that have less than $2 billion in assets and that, with affiliates, originate 500 or fewer mortgages a year. Small creditors that meet these criteria and do not generally have escrow accounts for their current mortgage customers will be exempt from the escrow requirements with regard to loans that are not subject to a forward commitment at origination.

Likewise, for the servicing rules, we recognize that smaller servicers typically operate according to a business model that is based on high-touch customer service, and that they typically make extensive efforts to avoid foreclosures. So smaller institutions that service 5,000 or fewer mortgage loans originated or owned by the servicer itself, or its affiliates, are exempted from large pieces of our servicing rules. This exempts many small servicers from, among other provisions, the periodic statement requirement, the general servicing policies and procedures, and most of the loss mitigation provisions.

We are committed to doing everything we can to help achieve effective, efficient, and comprehensive implementation by engaging with industry stakeholders in the coming year. To this end, we have announced an implementation plan to prepare mortgage businesses for the new rules. We will publish plain-English rule summaries, which should be especially helpful to smaller institutions. Over the course of the year, we will address questions, as appropriate, about the rules which are raised by industry, consumer groups, or other agencies. Any inquiries from your constituents in North Dakota about the meaning or intent of these regulations may be directed to CFPB_reginquiries@cfpb.gov or 202-435-7700. We will also publish readiness guides to give industry a broad checklist of things to do to prepare for the rules taking effect—like updating policies and procedures and providing training for staff. And we are working with our fellow regulators to help ensure consistency in our examinations of mortgage lenders under the new rules and to clarify issues as needed.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM ELISSE B. WALTER

Q.1. Given how complex it is to determine whether a trade is a hedge or a proprietary trade, it appears the real issue is whether a trade threatens the safety and soundness of the bank. What benchmark does your agency use to determine whether a particular activity is or is not "hedging"? How does your agency determine whether the trade presents risks to the safety and soundness of a financial institution?

A.1. In the proposed rules to implement Section 619 of the Dodd-Frank Act, commonly referred to as the "Volcker Rule", the SEC, the Federal banking agencies, and the CFTC set forth certain criteria intended to differentiate between permitted risk-mitigating hedging activities and prohibited proprietary trading. In particular, the proposed risk-mitigating hedging exemption required, among other things, that a banking entity's hedging activities: (i) hedge or otherwise mitigate one or more specific risks arising in connection with and related to individual or aggregated positions, contracts, or other holdings of the banking entity; (ii) be reasonably correlated to the risk(s) that are intended to be hedged or otherwise mitigated; and (iii) be subject to continuing review, monitoring, and management. Moreover, a banking entity would be required to establish an internal compliance program, including reasonably designed written policies and procedures regarding the instruments, techniques, and strategies that may be used for hedging, internal controls and monitoring procedures, and independent testing. Similar procedures and controls are currently used by large firms to manage their risk and by regulators who assess the risk of those firms. The proposed rules also required the use of particular metrics to help assess compliance with the Volcker Rule. Similar questions arise when determining whether hedging activity is being conducted in connection with market making activity in compliance with the market making exemption under the statute. Further, as specified in the statute, the proposed rules included a provision that would disallow a permissible activity, including risk-mitigating hedging, if the activity threatens the safety or soundness of the financial institution. We received a number of comments regarding these proposed rules. At this time, we are working with our fellow regulators to refine the proposed rules in response to comments.

Q.2. The SEC has not yet proposed its extraterritoriality rule for security-based swaps. Why has there been a delay and when do you intend to issue the proposed rules?

A.2. Since the time of this hearing, the Commission approved publication of its cross-border proposal on May 1, 2013. With very limited exception, the Commission had previously not addressed the regulation of cross-border security-based swap activities in our proposed or final rules because we believed these issues should be addressed holistically, rather than in a piecemeal fashion. In the Commission's view, a single proposal would allow investors, market participants, foreign regulators, and other interested parties with an opportunity to consider, as an integrated whole, the Commission's proposed approach.

Doing so, however, was a time-consuming process for two main reasons. First, we believed that the cross-border release should involve notice-and-comment rulemaking, not only interpretive guidance, and, as such, we needed to incorporate an economic analysis that reflected our consideration of the effects of the proposal on efficiency, competition, and capital formation. Although the rulemaking approach takes more time, we believe that this approach was worth the effort: a full articulation of the rationales for—and consideration of any reasonable alternative to—particular approaches should enable the public to better understand our proposed approach and clarify how we see the trade-offs inherent in these choices as we continue to consult with the CFTC and our colleagues in other jurisdictions regarding how best to regulate this global market.

Second, the scope of the proposal is broad and addresses the application of Title VII in the cross-border context with respect to each of the major registration categories covered by Title VII for security-based swaps: security-based swap dealers; major security-based swap participants; security-based swap clearing agencies; security-based swap data repositories; and security-based swap execution facilities. It also addresses the application of Title VII in connection with reporting and dissemination, clearing, and trade execution, as well as the sharing of information with regulators and related preservation of confidentiality with respect to data collected and maintained by security-based swap data repositories.

We believe that the proposal that the Commission approved in May reflects the effort that the Commission and its staff gave to fully considering the complex issues that invariably arise in any attempt to regulate a complex market that spans the globe.

Q.3. When will the SEC propose rules to implement the provisions of the JOBS Act concerning general solicitation for Regulation D, Rule 506 offerings? When will the SEC issue other rule proposals to implement the law?

A.3. Section 201(a) of the JOBS Act directs the Commission to amend Securities Act Rules 506 and 144A to eliminate, as a condition to both safe harbors, the ban against general solicitation. The Commission issued the rule proposal on August 29, 2012, and we received numerous comment letters with widely divergent views from commentators on this rulemaking. The staff has been working through the comments and developing recommendations for the Commission on how to move forward with this rulemaking as soon as possible. Completing this rulemaking, along with the other rulemaking required under the Dodd-Frank Act and the JOBS Act, is a priority for me.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNER FROM ELISSE B. WALTER

Q.1. The statutory language for funds defined under the Volcker Rule pointedly did not include venture funds, however the definition in the proposed rule seemed to indicate that venture funds would be covered. In addition to exceeding the statutory intent of Congress, this has created uncertainty in the market as firms await a final rule and refrain from making commitments which might be swept up in the final version of the Volcker Rule. Can you clarify whether venture funds are covered by the Volcker Rule?

A.1. The treatment of venture capital funds in the proposed rule implementing Section 619 of the Dodd-Frank Act (the Volcker Rule) is an issue that has been raised by several commenters.

The issue arises because Section 619 of the Dodd-Frank Act provides that a banking entity may not sponsor or invest in, or have certain other business relationships with, a hedge fund or private equity fund. However, Section 619 specifically defines hedge funds and private equity funds as issuers that would be investment companies under the Investment Company Act of 1940, but for Section 3(c)(1) or 3(c)(7). Sections 3(c)(1) and 3(c)(7) are statutory exemptions from the definition of investment company that are commonly used by hedge funds and private equity funds, but also are routinely used by venture capital funds and other entities. In addition, in Title IV of the Dodd-Frank Act, Congress referred to venture capital as a "subset" of private equity when it provided venture capital advisers (and not private equity advisers) with an exemption from registration as investment advisers with the SEC.

The proposed rule to implement Section 619 adhered closely to the language of the Dodd-Frank Act and defined hedge funds and private equity funds as issuers relying on the exemption in Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Many commenters have noted that this language would pick up many more types of vehicles than the hedge funds and private equity funds that are specifically referenced in the statute and that many commenters believe should be the main focus of the Volcker Rule prohibitions. In particular, many commenters have recommended that the SEC and other regulators implementing Section 619 revise the rule to exempt venture capital funds from Section 619's prohibitions, in part in light of the impact that venture capital funds can have on U.S. economic growth and job creation.

Our staff continues to work closely with staff from the bank regulatory agencies and the CFTC to determine whether the proposed definition can be refined and whether it would be appropriate to exempt any entities or funds in light of the statute and its goals, including Section 619's provision that the agencies may exempt any activity from the implementing rule upon a finding that such activity would promote and protect the safety and soundness of banking entities.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM ELISSE B. WALTER

Q.1. As you know, the SEC has faced repeated attempts from Congress over the years to significantly cut its funding. Two years ago, as one example, Republicans in the House of Representatives sought to cut the President's proposed budget for the Commission by $222.5 million—or about 15 percent. I am interested, given the repeated assaults on SEC's funding, to learn more about the impact this sort of cut would have on the Commission's functioning.

Can you describe in particular what impact a cut of that magnitude would have on the SEC's enforcement capacity and the Commission's ability to hold those who break the law accountable?

A.1. Reducing the SEC's budget at this critical juncture—in the aftermath of the fiscal crisis and after the SEC has been granted significant new responsibilities—would diminish both our ability to police rapidly changing markets and the faith of the investing public. The Commission's Enforcement program, which is charged with investigating and prosecuting violations of the Federal securities laws, has sought to maximize limited resources to address evermore complex and sophisticated fraudulent schemes. Three years ago, the Enforcement Division undertook a historic restructuring that, among other things, streamlined its management and created specialized units to pursue priority areas. As a result, the Commission has been better able to identify, investigate, and punish wrongdoing quickly and effectively. Our success in pursuing misconduct during the financial crisis, hedge fund and expert network insider trading, market structure deficiencies, and Ponzi and other offering frauds is a testament to the effectiveness of these efforts.

A budget cut would only serve to magnify and accentuate the challenges brought on by the increase in the number of individuals and entities falling within our jurisdiction, the growing number of complex securities offered to the public, and the accelerating pace of financial innovation that has already fundamentally changed our markets.

Currently, the SEC oversees approximately 25,000 entities, including about 11,000 registered investment advisers, 9,700 mutual funds and exchange traded funds, and 4,600 broker-dealers with more than 160,000 branch offices. The SEC also has responsibility for reviewing the disclosures and financial statements of approximately 9,000 reporting companies. In addition, the SEC oversees approximately 460 transfer agents, 17 national securities exchanges, 8 active clearing agencies, and 10 nationally recognized statistical rating organizations (NRSROs), as well as the Public Company Accounting Oversight Board (PCAOB), Financial Industry Regulatory Authority (FINRA), Municipal Securities Rulemaking Board (MSRB), and the Securities Investor Protection Corporation (SIPC). The agency also has new or expanded responsibilities over the derivatives markets, hedge fund and other private fund advisers, municipal advisors, credit rating agencies, and clearing agencies.

Enforcement is expected to shoulder additional work as a result of our expanded authority under the Dodd-Frank Act. For example, the Enforcement program is responsible for triaging and investigating additional tips and complaints received under the whistleblower program mandated by the Dodd-Frank Act. Although several thousand smaller advisers are transitioning to State registration due to the Dodd-Frank, the addition of entities such as municipal advisors, securities-based swap entities, and hedge fund and other private fund advisers to the Commission's jurisdiction has resulted in an increase in the number of referrals to the Enforcement program.

The sheer number of persons and entities falling within the Commission's jurisdiction reflects only part of the challenge. These registrants offer ever-changing products in the market, from traditional bonds and stocks to structured financial instruments to derivatives, such as credit default swaps, that require expertise in understanding of the products, the trading methods, and the inherent risks. In addition, markets and companies also are becoming increasingly global, creating a new set of complexities, including the comparability of information from different countries and cross-border enforcement. As product offerings and fraudsters become more sophisticated, the complexity of enforcement cases increases and requires more resources dedicated to achieving a successful resolution.

Furthermore, the Enforcement program must confront the risks to a fair securities marketplace posed by increasingly complex and fragmented market structures, alternative trading systems, and high-speed electronic trading. These innovations, fueled by technological advances, have resulted in a fundamental shift in market process and behavior. We must ensure that these innovations do not outpace our efforts to guard against illegal behavior masked by opaque trading platforms or the millions of bids, offers, buys, or sells that can be generated in milliseconds by automated computer algorithms.

Amidst these challenges, we are under-resourced and lack sufficient human capital, expertise, and technology to address the ever more multifaceted and difficult-to-detect misconduct that threatens investors and the markets. In both FY2013 and FY2014, the SEC is requesting funds to hire additional attorneys, trial lawyers, industry experts, forensic accountants, and paraprofessionals for the Enforcement program, to maintain the momentum of our recent enforcement activities and strive to keep pace with markets of growing size and complexity. Our inability to hire additional staff and augment our capabilities will weaken the our investigative and litigation functions; reduce our ability to obtain, process, and analyze critical market intelligence; inhibit the adoption of valuable information technology and state-of-the-art investigative tools; and further reduce our ability to collect on ordered disgorgement and penalties, and distribute monies back to harmed investors. Further, our ability to proactively identify hidden or emerging threats to the markets to halt misconduct and minimize investor harm, adequately address complex financial products and transactions, handle the increasing size and complexity of the securities markets, identify emerging threats and take prompt action to halt violations, and recover funds for the benefit of harmed investors would be severely hindered.

Q.2. Has the SEC conducted any internal research or analysis on trade-offs to the public between settling an enforcement action without admission of guilt and going forward with litigation as necessary to obtain such admission?

If so, can you provide that analysis to the Committee?

A.2. The Commission is rigorous and methodical in analyzing each offer to settle an enforcement action. While we have not conducted a macro-analysis of the trade-offs to the public between settling an enforcement action without an admission of guilt or wrongdoing and going forward with litigation, every settlement offer is analyzed on a case-by-case basis in light of the unique facts and circumstances of that specific case.

Recently, we reviewed our approach to ensure we make full and appropriate use of our leverage in the settlement process, including a discussion of the neither-admit-nor-deny approach. While the no admit/deny language is a powerful tool, there may be situations where we determine that a different approach is appropriate.

We currently do not enter no-admit-no-deny settlements in cases in which the defendant admitted certain facts as part of a guilty plea or other criminal or regulatory agreement. Beyond this category of cases, there may be other situations that justify requiring the defendant's admission of allegations in our complaint or other acknowledgment of the alleged misconduct as part of any settlement. In particular, there may be certain cases where heightened accountability or acceptance of responsibility through the defendant's admission of misconduct may be appropriate, even if it does not allow us to achieve a prompt resolution. Staff from the Division of Enforcement have been in discussions with Chair White and each of the Commissioners about the types of cases where requiring admissions could be in the public interest. These may include misconduct that harmed large numbers of investors or placed investors or the market at risk of potentially serious harm; where admissions might safeguard against risks posed by the defendant to the investing public, particularly when the defendant engaged in egregious intentional misconduct; or when the defendant engaged in unlawful obstruction of the Commission's investigative processes. In such cases, should we determine that admissions or other acknowledgement of misconduct are critical, we would require such admissions or acknowledgement, or, if the defendants refuse, litigate the case.

Of course, we recognize that insisting upon admissions in certain cases could delay the resolution of cases, and that many cases will not fit the criteria for admissions. For these reasons, no-admit-no-deny settlements will continue to serve an important role in our mission and most cases will continue to be resolved on that basis. No-admit-no-deny settlements achieve a significant measure of accountability and deterrence because of the detailed factual allegations and findings contained in our complaints, orders instituting proceedings, and settlement documents—factual allegations or findings that present a virtual road map of the wrongdoing that the Commission contends violated the Federal securities laws. In addition, the very public nature of our settlements enhances their deterrent impact—our settlements frequently are accompanied by press releases, dissected by the media, analyzed in detail by the financial industry and the defense bar in various public forums, and are the subject of speeches and other public statements by the Chair, the Commissioners, and other SEC officials.

There is, in fact, economic research that indicates that SEC settlements have consequences for firms as well as management and directors. For instance, a group of economists found that the reputational penalties to a firm of an SEC enforcement action for financial fraud are highly significant: for each dollar that a firm misleadingly inflates its market value, on average, it loses both this dollar plus an additional $3.08 when its misconducts is revealed (Jonathan M. Karpoff, D. Scott Lee, and Gerald S. Martin, “The Cost to Firms of Cooking the Books”, 43 *Journal of Financial and Quantitative Analysis,* 2008). The same economists studied 2,206 individuals identified as responsible parties for 788 SEC and Department of Justice enforcement actions for financial misrepresentation from 1978 through mid-2006. They found that 93 percent of the individuals lose their jobs by the end of the regulatory enforcement period, with the majority being explicitly fired (Karpoff, Lee, and Martin, “The Consequences to Managers for Financial Misrepresentation”, 88 *Journal of Financial Economics,* 2008). In addition, economists have found that when the SEC settles a case, outside directors experience a decline in the number of other board positions held (Eliezer Fich and Anil Shivdasani, “Financial Fraud, Director Reputation, and Shareholder Wealth”, 86 *Journal of Financial Economics*, 2007, and Eric Helland, “Reputational Penalties and the Merits of Class-Action Securities Litigation”, 49 *Journal of Law and Economics,* 2006).

Q.3. In Section 953(b) of the Dodd-Frank Act, Congress required the SEC to issue a regulation mandating that companies disclose the ratio of pay between the company’s CEO and the company’s median employee. This disclosure requirement is intended to help investors evaluate total levels of CEO pay relative to other company employees. Many investors want to know about these pay ratios because high pay disparities between the CEO and other employees—particularly in a time of economic belt tightening—can result in lower employee morale, reduced productivity, and higher turnover, thereby signaling economic trouble for the company. It has now been more than 2 years since the SEC issued its rule implementing the Dodd-Frank “say-on-pay” vote requirement, but the SEC has not yet issued a rule implementing Section 953(b).

Why hasn’t the SEC issued rules implementing Section 953(b)? When will these rules be issued?

A.3. As I noted in my testimony, the Commission has made substantial progress in writing the huge volume of new rules the Dodd-Frank Act directs, but I recognize there is more work to do. The Commission and the staff are continuing to work diligently to implement the provisions of the Dodd-Frank Act, including Section

953(b), while balancing that work our other responsibilities, including the implementation of the provisions of the JOBS Act. The staff is actively working on developing recommendations for the Commission concerning the implementation of Section 953(b), which requires the Commission to implement rules requiring disclosure of the CEO's annual total compensation, the median of the annual total compensation paid to all employees other than the CEO and the ratio between the two numbers.

This rulemaking raises a number of new issues for the Commission and registrants that require careful consideration. As evidenced in the public comment file on the Commission's Web site, which includes more than 20,000 comment letters relating to this rulemaking, the comments reflect a wide range of views concerning the implementation of the provision and the potential costs and benefits associated with the requirements. The staff is carefully reviewing and analyzing these comments as it develops recommendations for the Commission.

Q.4. [Response to question during the hearing from Senator Warren]: "When was the last time you took a big Wall Street bank to trial?"

A.4. We are fully prepared to go to trial every time we bring an enforcement action, but we believe there is no reason to delay justice and relief for investors when we can obtain through a settlement the relief that we could reasonably expect to receive at trial, without the delay of a lengthy and protracted litigation. We also believe that SEC settlements achieve a significant measure of accountability and deterrence because of the detailed factual allegations contained in our complaints and settlement documents—factual allegations that present a virtual road map of the wrongdoing that we contend violated the Federal securities laws. In addition, the very public nature of our settlements enhances their deterrent impact—our settlements often are accompanied by press releases, dissected by the media, analyzed in detail by the financial industry and the defense bar in various public forums, and are the subject of speeches and other public statements by the Chairman, the Commissioners, and other SEC officials.

The reality is, as trial-ready as we may be, Wall Street banks and other large public companies often weigh the risks of litigating to trial against the SEC—including the risk of loss, litigation costs, reputational damage and other factors—and choose instead to offer a proposed settlement. On the other hand, individuals may weigh the risks of litigating against the SEC differently than do large banks and public companies, particularly given that our settlements often include remedies such as industry bars that restrict an individual's ability to earn a living in the financial industry.

While the SEC will continue to settle many of the cases that it files, the calculus for whether we settle or litigate a case will change under a new shift in approach to our traditional settlement policy. Recently, the Enforcement Division, in consultation with the Chair White and the other Commissioners, reviewed the SEC's settlement policy and provided guidance to Enforcement staff about the types of cases where requiring a defendant, as part of a settlement, to admit the SEC's allegations could be in the public interest. These cases may include those where the misconduct harmed large numbers of investors or placed investors or the market at risk of potentially serious harm; where admissions might safeguard against risks posed by the defendant to the investing public, particularly when the defendant engaged in egregious intentional misconduct; or when the defendant engaged in unlawful obstruction of the Commission's investigative processes. In such cases, should we determine that admissions or other acknowledgement of misconduct are critical, we would require such admissions or acknowledgement, or, if the defendant refuses, litigate the case. Even under this shift in approach, many cases will not fit the criteria for admissions. Accordingly, no-admit-no-deny settlements will continue to serve an important role in the SEC's mission and most cases will continue to be resolved on that basis.

Regarding your particular question about litigating with large financial institutions, we have filed a significant number of litigated actions—actions where we stood ready to go to trial—in our financial crisis-related cases against individuals, many of whom were CEOs, CFOs, or other senior executives at major Wall Street banks or financial institutions. In total, we have filed crisis-related actions against 105 individuals—70 percent of which were filed as contested actions—employed by Goldman Sachs, J.P. Morgan, Citigroup, Wells Fargo, Bear Stearns, Bank of America, Fannie Mae, Freddie Mac, Countrywide, New Century, and other large financial firms.

As to actions against particular Wall Street banks, our April 2012 financial crisis-related case against Goldman Sachs arising from the Abacus CDO transaction was a contested litigated action before resolving in a landmark $550 million settlement that also required Goldman Sachs to make various compliance reforms. We continue to actively litigate towards an upcoming trial against Fabrice Tourre, the Goldman Sachs Vice President primarily responsible for structuring and marketing the transaction.

A major firm, if not a major bank, we litigated to trial against the Reserve Fund Management Co., the investment firm running the $62 billion Reserve Primary Fund money-market fund that fell below $1 per share—breaking the buck, in Wall Street vernacular—when its $785 million in Lehman debt was rendered worthless in bankruptcy. We also litigated to trial against Bruce Bent, Sr., and his son, Bruce Bent II, for their conduct in allegedly deceiving investors about the risks facing the Reserve Fund after Lehman's September 2008 collapse. The jury found that Reserve Management and a related brokerage operation, Resrv Partners Inc., violated antifraud provisions of the Federal securities laws and also found Bruce Bent II liable for one negligence claim.

We also engaged in extended litigation against Brookstreet Securities Corporation, a California-based broker-dealer, along with its CEO, and several registered representatives for systemically selling risky mortgage-backed securities to retirees and other customers with conservative investment goals as the housing market was collapsing during the financial crisis. After nearly 3 years of litigation first initiated in December 2009, we won summary judgment—just before trial—against Brookstreet Securities and its CEO and both were ordered to pay a maximum penalty of $10 million, plus disgorgement. The Brookstreet registered representatives went to trial and we are still awaiting a final decision.

In sum, we think that our policy of obtaining settlements where they reasonably approximate what we could achieve at trial is an effective way to hold accountable those entities and individuals whom we believe to have violated the Federal securities laws far sooner than through protracted litigation. Although we believe our settlement policy is in the public interest we certainly stand ready and able to litigate to trial—a willingness that only strengthens our negotiation position when crafting a settlement that benefits and protects investors.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM ELISSE B. WALTER

Q.1. Section 120 of the Dodd-Frank Act states that "[t]he Council shall consult with the primary financial regulatory agencies [. . .] for any proposed recommendation that the primary financial regulatory agencies apply new or heightened standards and safeguards for a financial activity or practice." In its November 2012 release on money market fund regulatory proposals, FSOC states that "in accordance with Section 120 of the Dodd-Frank Act, the Council has consulted with the SEC staff." It is my understanding that FSOC did not consult with any of the SEC Commissioners serving at the time.

Given that the SEC is solely governed by the commissioners, and especially considering that SEC staff serves at the will of the SEC Chairman rather than all Commissioners, how would such consultations with staff fulfill this statutory obligation going forward?

A.1. The Dodd-Frank Act contains numerous consultation requirements applicable to the SEC, including requirements for the SEC to consult with other agencies, or for other agencies to consult with the SEC, in connection with rulemaking and other actions. These consultations typically involve discussions and coordination with staff, including senior staff, of the relevant agencies, which is consistent with the traditional way that agencies Government-wide have performed interagency consultations under numerous statutes. In developing its proposed recommendations for money market mutual fund reform, and consistent with the traditional manner of consultation, the FSOC consulted with the SEC staff.

Q.2. What research has FSOC done to determine the reduction in assets held in money market funds that could result from the proposed section 120 recommendations?

Have you done anything to quantify the economic effect of a substantial shift in assets from prime money market funds to Treasury money market funds, banks, or unregulated investment funds?

A.2. I cannot speak to what research the FSOC did prior to issuing its Section 120 report, beyond what may be in those recommendations. The SEC's recent rule proposal addressing potential money market fund reform generally tackled the difficult questions regarding the potential economic impacts of various reform alternatives and specifically addressed the question of whether there will be a reduction in assets held by money market funds and if so, where those assets may go. The proposing release explicitly acknowledges that investors may withdraw some of their assets from affected money market funds. At the same time, however, the proposal makes clear that the SEC cannot make reliable estimates of the amount of dollars that will leave the industry or where those dollars will likely go.

The release provides information regarding the holdings of money market funds, including the fraction of various types of securities that have been held by the money market fund industry (for example, Treasury securities, commercial paper, and certificates of deposit). This information demonstrates that money market funds are important players in certain asset classes. The release does not, however, directly estimate what might happen were money market funds to withdraw from certain asset classes. Quantifying the effects of movements from money market funds to other investment alternatives is challenging because the SEC is unable to estimate how the investment alternatives would invest the new monies. For example, if institutional investors moved their monies from prime money market funds to unregulated investment funds, it is possible that the unregulated investment funds would ultimately choose to invest in the same assets that were held previously by the prime money market funds. If this were to happen, the effects on issuers and the short-term financing markets would be negligible. However, there could be substantive effects if the unregulated investment funds invested in substantively different assets. Given the uncertainty, it is difficult to quantify those effects.

The release contains questions on this issue and we look forward to receiving comments from the public. Moreover, the SEC's proposal includes an expansion of the data required to be filed with the SEC regarding unregistered investment funds, known as "liquidity funds," that potentially could serve as an alternative to registered money market funds. Such data would enable the SEC and the FSOC to monitor any growth in such funds as well as identify the asset classes in which those funds invest.

Q.3. Under Title V—Private Company Flexibility and Growth, Section 501 Threshold for Registration will the Securities and Exchange Commission provide guidance as to the process for determining whether a shareholder meets the "accredited investor" definition for purposes of the JOBS Act?

A.3. As you know, under Title V of the JOBS Act, an issuer that is not a bank or bank holding company is required to register a class of equity securities within 120 days after its fiscal year end, if on the last day of its fiscal year it has total assets of more than $10 million and a class of equity securities, other than an exempted security, held of record by either 2,000 persons or 500 persons who are not accredited investors.

I understand that companies are uncertain about how to establish and track which shareholders qualify as accredited investors in order to be able to comply with this provision, particularly because investors, especially investors in secondary market transactions, do not have current or ongoing obligations to provide information to the issuer or the issuer's agent as to whether or not they are accredited investors. Although the changes to Section 12(g) of the Exchange Act were effective upon enactment, the Commission will need to amend certain rules to reflect these statutory changes. The issue of how a company would determine whether a shareholder qualifies as an accredited investor for purposes of determining the number of holders of record is one that the Commission's staff is aware of and is carefully considering as it prepares recommendations for the Commission.

Q.4. Under Title V—Private Company Flexibility and Growth, Section 502 Employees are family members (including heirs of the employee and trusts established by the employee) included in the definition of persons for purposes of the following: "securities held by persons who received the securities pursuant to an employee compensation plan in transactions exempted from the registration requirements of section 5 of the Securities Act of 1933"?

A.4. In addition to raising the total assets and shareholder thresholds that require registration of a class of security by companies other than banks and bank holding companies, Title V of the JOBS Act excludes shares held by those who received them pursuant to employee compensation plans from inclusion in the number of holders of record. Title V also requires the Commission to adopt a safe harbor for the determination of whether such a holder received the securities pursuant to an employee compensation plan that was exempt from the registration requirements of Securities Act Section 5. The issue of transfers among family members as it applies to the exclusion of employee compensation plan securities under Section 12(g) is one that the Commission's staff is aware of and is carefully considering as it prepares its recommendations for the Commission.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CRAPO FROM GARY GENSLER

Q.1. Given how complex it is to determine whether a trade is a hedge or a proprietary trade, it appears the real issue is whether a trade threatens the safety and soundness of the bank. What benchmark does your agency use to determine whether a particular activity is or is not "hedging"? How does your agency determine whether the trade presents risks to the safety and soundness of a financial institution?

A.1. The Dodd-Frank Act requires that the CFTC, the Federal Reserve Board, the Securities and Exchange Commission, the Office of the Comptroller Currency, and the Federal Deposit Insurance Corporation write regulations that implement the Volcker Rule. The CFTC's related Proposed Rule was published on February 14, 2012, along with request for public comment. The Proposed Rule describes seven criteria that a banking entity must meet in order to rely on the hedging exemption. Included is a condition that the transaction in question hedge or otherwise mitigate one or more specific risks, that the transaction be reasonably correlated to the risk or risks the transaction is intended to hedge, that the hedging transaction not give rise to significant exposures that are not themselves hedged in a contemporaneous transaction, and other related conditions. The CFTC and the other agencies are in the process of evaluating and reviewing each of the comments that were received on the proposed Volcker Rule and will address those comments in a Final Rule.

Q.2. Last year the CFTC issued proposed interpretive guidance on cross-border application of the swaps provisions of Dodd-Frank, the so-called extraterritoriality guidance. This guidance received widespread criticism from foreign regulators across the globe for, among other things, not conforming to a G20 agreement, being too expansive in scope and confusing in application. Recently, the CFTC approved an exemptive order delaying the effective date for some of the provisions and issued further cross-border guidance in an attempt to clarify the scope and definition of "U.S. person." However, at least one foreign regulator (The Financial Services Agency of the Government of Japan) sent you a letter stating that the further guidance made the definition even less clear. What steps is the CFTC taking to address those concerns?

A.2. The Commission is reviewing, summarizing, and considering all comments received as it works toward finalizing the cross-border guidance. We are also working bilaterally with domestic and foreign regulators, including the Japanese Financial Services Authority (JFSA), to answer any questions and discuss any issues they have regarding the CFTC's proposals.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

HIGHLIGHTS OF GAO-13-180: FINANCIAL CRISIS LOSSES AND POTENTIAL IMPACTS OF THE DODD-FRANK ACT, JANUARY 2013

GAO
Accountability * Integrity * Reliability

Highlights

Highlights of GAO-13-180, a report to congressional requesters

January 2013

FINANCIAL REGULATORY REFORM

Financial Crisis Losses and Potential Impacts of the Dodd-Frank Act

Why GAO Did This Study

The 2007-2009 financial crisis threatened the stability of the U.S. financial system and the health of the U.S. economy. To address regulatory gaps and other problems revealed by the crisis, Congress enacted the Dodd-Frank Act. Federal regulators will need to issue hundreds of rules to implement the act. Industry representatives, academics, and others generally have supported the act's goal of enhancing U.S. financial stability, but implementation of certain of the act's provisions has led to much debate. These experts have expressed a wide range of views on the potential positive and negative effects that the act could have on the U.S. financial system and broader economy.

GAO was asked to examine the (1) losses associated with the recent financial crisis; (2) benefits of the act for the U.S. financial system and the broader economy; and (3) costs of the act's reforms. GAO reviewed empirical and other studies on the impacts of financial crises and the Dodd-Frank reforms, as well as congressional testimonies, comment letters, and other public statements by federal regulators, industry representatives, and others. GAO obtained and analyzed data on agency resources devoted to the act's implementation. GAO also obtained perspectives from regulators, academics, and representatives of industry and public interest groups through interviews and an expert roundtable held with the assistance of the National Academy of Sciences. GAO provided a draft of this report to the financial regulators for review and comment and received technical comments, which were incorporated as appropriate.

View GAO-13-180. For more information, contact A. Nicole Clowers at (202) 512-8678 or clowersa@gao.gov.

What GAO Found

The 2007-2009 financial crisis has been associated with large economic losses and increased fiscal challenges. Studies estimating the losses of financial crises based on lost output (value of goods and services not produced) suggest losses associated with the recent crisis could range from a few trillion dollars to over $10 trillion. Also associated with the crisis were large declines in employment, household wealth, and other economic indicators. Some studies suggest the crisis could have long-lasting effects: for example, high unemployment, if persistent, could lead to skill erosion and lower future earnings for those affected. Finally, since the crisis began, federal, state, and local governments have faced greater fiscal challenges, in part because of reduced tax revenues from lower economic activity and increased spending to mitigate the impact of the recession.

While the Dodd-Frank Wall Street Reform and Consumer Protection Act's (Dodd-Frank Act) reforms could enhance the stability of the U.S. financial system and provide other benefits, the extent to which such benefits materialize will depend on many factors whose effects are difficult to predict. According to some academics, industry representatives, and others, a number of the act's provisions could help reduce the probability or severity of a future crisis and thereby avoid or reduce the associated losses. These include subjecting large, complex financial institutions to enhanced prudential supervision, authorizing regulators to liquidate a financial firm whose failure could pose systemic risk, and regulating certain complex financial instruments. In contrast, some experts maintain these measures will not help reduce the probability or severity of a future crisis, while others note that their effectiveness will depend on how they are implemented by regulators, including through their rulemakings, and other factors, such as how financial firms respond to the new requirements. Quantifying the act's potential benefits is difficult, but several studies have framed potential benefits of certain reforms by estimating output losses that could be avoided if the reforms lowered the probability of a future crisis.

Federal agencies and the financial industry are expending resources to implement and comply with the Dodd-Frank Act. First, federal agencies are devoting resources to fulfill rulemaking and other new regulatory responsibilities created by the act. Many of these agencies do not receive any congressional appropriations, limiting federal budget impacts. Second, the act imposes compliance and other costs on financial institutions and restricts their business activities in ways that may affect the provision of financial products and services. While regulators and others have collected some data on these costs, no comprehensive data exist. Some experts stated that many of the act's reforms serve to impose costs on financial firms to reduce the risks they pose to the financial system. Third, in response to reforms, financial institutions may pass increased costs on to their customers. For example, banks could charge more for their loans or other services, which could reduce economic growth. Although certain costs, such as paperwork costs, can be quantified, other costs, such as the act's impact on the economy, cannot be easily quantified. Studies have estimated the economic impact of certain of the act's reforms, but their results vary widely and depend on key assumptions. Finally, some experts expressed concern about the act's potential unintended consequences and their related costs, adding to the challenges of assessing the benefits and costs of the act.

United States Government Accountability Office

SUBMITTED WRITTEN TESTIMONY OF CHRISTY ROMERO, SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM (SIGTARP)

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, I want to thank you for holding today's hearing on Wall Street reform and an oversight of our Nation's financial stability. The Office of the Special Inspector General for the Troubled Asset Relief Program (SIGTARP) serves as the watchdog over the Troubled Asset Relief Program (TARP), the Federal bailout resulting from the financial crisis. SIGTARP protects the interests of those who funded TARP programs—American taxpayers. Our mission is to promote economic stability through transparency, robust enforcement, and coordinated oversight.

In order to determine where our Nation stands today in terms of Wall Street reforms and financial stability oversight, we must understand how our Nation found itself in a financial crisis and a bailout in 2008. SIGTARP has examined the past actions by Wall Street institutions that made them "too big to fail" and led to the TARP bailout. The issues that arose in the wake of the financial crisis, and our Government's response, have implications for the future. Indeed, the Congressional hearings on the Dodd-Frank Wall Street Reform and Consumer Protection Act are largely focused on the reasons why Treasury and the Federal banking regulators believed that these institutions were "too big to fail" requiring a TARP bailout, and the reforms that were needed to prevent future bailouts. Only by examining the past, can we take advantage of lessons learned to protect taxpayers better in the future.

Four years after the passage of the TARP bailout, critical questions remain prevalent about financial stability and Wall Street reform. Does moral hazard still exist? Is our financial system still vulnerable to companies that were considered "too big to fail?" Do taxpayers have a stronger, more stable financial system that is less prone to crisis—one in which the U.S. Government need not intervene to rescue a failing institution—as an owner or a shareholder—or else risk financial collapse? Taxpayers need and deserve lasting change arising out of the 2008 financial crisis.

While there have been significant reforms to our financial system over the past 4 years, more change is needed to address the root causes of the financial crisis and the resulting bailout, including vulnerabilities to highly interconnected institutions, and past failures in risk management. Financial institutions, regulators, and Treasury have a benefit that was missing during the financial crisis: the benefit of time . . . time to shore up existing strengths and to minimize vulnerabilities.

There are lessons to be learned from the 2008 financial crisis and TARP. And as history has a way of repeating itself, we must take those lessons learned and put into place the changes that will bring a safer tomorrow—a future in which the flaws and excesses of corporate America do not create an undertow for families and small businesses.

Too Interconnected To Fail

One of the most important lessons of TARP and the financial crisis is that our financial system remains vulnerable to companies that can be deemed "too interconnected to fail." In 2008, we learned that our financial system was akin to a house of cards, with a foundation built on businesses that were "too big to fail." But these businesses were not only too big to fail, in and of themselves, they also were highly interconnected. If one were to fall, the house of cards could collapse.

When the crisis hit, regulators were ill-prepared to protect taxpayers because they had failed to appreciate the interconnected nature of our financial system, and the resulting threats to American jobs, retirement plans, mortgages, and loans. Thus, Treasury and regulators turned to TARP.

These same financial institutions continue to form the foundation of our economy. They continue to be dangerously interconnected. And, in fact, they have only gotten bigger in the past 4 years.[1] In 2012, the Federal Reserve Bank of Dallas reported that the biggest banks have grown larger still because of artificial advantages, particularly the widespread belief that the Government will step in to rescue the creditors of the biggest institutions if necessary—a belief underscored by TARP.

Whether Dodd-Frank's newly created resolution authority will ultimately be successful in ending "too big to fail" will depend on the actions taken by regulators and Treasury. Notwithstanding the passage of Dodd-Frank, the FRB Dallas reports that

[1] According to Federal Reserve data, as of September 30, 2012, the top five banking institutions (all TARP recipients) held \$8.7 trillion in assets, equal to approximately 55 percent of our Nation's gross domestic product. By comparison, before the financial crisis, these institutions held \$6.1 trillion in assets, equal to 43 percent of GDP.

the sheer size of these institutions—and the presumed guarantee of Government support in time of crisis—have provided a "significant edge—perhaps a percentage point or more—in the cost of raising funds." In other words, cheaper credit translates into greater profit.

After Dodd-Frank, credit rating agencies began including the prospect of Government support in determining credit ratings. In 2011, Moody's downgraded three institutions citing a decrease in the probability that the Government would support them, while stating that the probability of support for highly interconnected institutions was very high. Recently, a Moody's official stated that Government support was receding.

It is too early to tell whether full implementation of Dodd-Frank will ameliorate the need for taxpayers to bail out companies if there is a future crisis. Even without the failure of any one of these institutions, we have learned that their near failure or significant distress could cause ripple effects for families and businesses. Despite TARP and other Federal efforts preventing the failure of these institutions, much of Americans' household wealth evaporated. Treasury Secretary Timothy F. Geithner testified before Congress in a hearing on Dodd-Frank that there was a "threat of contagion" caused by the interconnectedness of major firms. Given this continued "threat of contagion" to our financial system, Treasury and regulators should take this opportunity to protect taxpayers from the possibility of any future financial crisis.

Through Dodd-Frank, Congress significantly reformed the regulators' authority to hold "systemically important" institutions to higher standards. However, it remains unclear how regulators will use that authority, and to what degree. The determination of which nonbank institutions are considered systemic also remains unclear. In addition, companies previously described as systemic, such as AIG, have gone without financial regulation for years. Despite the fact that the identity of banks that will be subject to higher standards has been known for 2 years, the standards for these companies are far from final. Regulators have moved more slowly than expected, due in part to strong lobbying efforts against change.

Treasury and regulators must provide incentives to the largest, most interconnected institutions to minimize both their complexity and their interconnectedness. Treasury and regulators should send clear signals to the financial industry about levels of complexity and interconnectedness that will not be accepted. Treasury and regulators must set the standards through increased capital and liquidity requirements to absorb losses, as well as tighter margin standards. Treasury and regulators should limit risk through constraints on leverage. And companies, in turn, must do their part.

Risk Management

Companies must engage in effective risk management, and regulators must supervise this risk management. According to Treasury Secretary Geithner's Congressional testimony in support of Dodd-Frank, the biggest failure in our financial system was that it allowed large institutions to take on leverage without constraint. Leverage—debt or derivatives used to increase return—has risk because it can multiply gains and losses. Large interconnected financial institutions had woefully inadequate risk management policies, which allowed problems to intensify.[2] Financial institutions made risky subprime mortgages, which they then sliced, diced, and repackaged into complex mortgage derivatives to be sold to each other and to other investors. These companies and investors were heavily dependent on inflated credit ratings. Institutions bought these long-term illiquid securities with short-term funding that froze in 2008, causing severe liquidity crises. Treasury asked Congress to approve TARP because these illiquid mortgage assets had, in essence, choked off credit.

Insufficient attention was placed on counterparty risk, with many of the companies believing they were "fully hedged" with zero risk exposure. Companies developed elaborate methods of hedging, including buying insurance-like protection against the default of these investments (called credit default swaps). Companies hedged through offsetting trades that bet on the increase and decrease in the value of the security. These hedges, many of which did not fully protect against exposure, provided a false sense of protection that led to decreased risk management and decreased market discipline.

The financial system was opaque, impeding an understanding of the true exposure to risk by institutions, rating agencies, investors, creditors, and regulators. Products such as credit default swaps went unregulated. Offsetting trades occurred on the

[2] Testimony of Treasury Secretary Henry Paulson, Financial Crisis Inquiry Commission, May 6, 2010.

over-the-counter market—a market that, unlike the New York Stock Exchange or other exchanges, has no transparency. With no effective curbs on risk, executives often ignored risk, with many receiving extraordinary pay based on how many mortgages they created, while at the same time transferring their risk in the ultimate success of the mortgages. In short, Wall Street cared more about dollars than sense. And yet, we must ask ourselves: Has anything changed?

In 2008, the U.S. Government assured the world that it would use TARP and access to the Federal Reserve's discount window to prevent the failure of any major financial institution. But in so doing, it encouraged future high-risk behavior by insulating the risk-takers from the consequences of failure. This concept—known as moral hazard—is alive and well. A 2012 study by Federal Reserve economists found that large TARP banks have actually increased the number of loans that could be considered "risky," which "may reflect the conflicting influences of Government ownership on bank behavior." Fannie Mae and Freddie Mac also operated with an implicit Government guarantee, which led to lower borrowing costs that enabled them to take on significant leverage. According to Treasury, these entities "were a core part of what went wrong with our system."[3] Dodd-Frank did not address Fannie Mae and Freddie Mac.

Financial institutions must practice discipline and responsibility by reforming risk management and corporate governance. Companies cannot write off risk management believing that their exposure is removed by hedging. Companies must understand their exposure to risk, including conducting heightened reviews of counterparty risk.

Recent scandals such as JPMorgan's "London whale" and LIBOR manipulation have shown that excessive risk-taking continues unchecked by executives and boards of directors. Companies should make a deeper assessment of their assets. Assets carry different amounts of risk; collateral for some loans may be stronger than others. In determining the amount of TARP funds to invest in a bank, Treasury used the total risk-weighted assets, rather than total assets. Executives and boards must better understand, monitor, and manage risk.

We learned from the crisis that we cannot expect companies to constrain excess risk-taking on their own initiative. Regulators therefore must protect hardworking Americans by setting constraints on leverage. Given their interconnectedness, risk at one institution (Lehman Brothers, for example) can shock our entire system. Our regulators must require "strong shock absorbers," as described by Treasury Secretary Geithner.

Bank examiners must increase their supervision of risk management at all banks, and the supervision of companies that pose a risk to our financial system must be even stronger. Regulators can use information from on-site examiners, Federal Reserve stress tests, and plans called "living wills" (submitted by these companies) to determine areas of risk. While regulators are still going through the process to write rules establishing these standards, other rules have not yet been written.

Treasury and regulators should set strong capital requirements and liquidity cushions to absorb shock; longer-term funding to prevent a liquidity crisis; strong rules regarding leverage; and constraints on specific products or lines of business that hide true exposure to risk.

In the wake of the 2008 financial crisis, we realized that change was necessary. There has been meaningful change to our financial system. But there is much more to be done. Americans need and deserve a financial system with regulation that encourages growth, but that minimizes susceptibility to current risks—and one that is flexible enough to protect against emerging risks. Treasury and regulators must have courage and steely resolve to enact change as they are up against Wall Street executives who simply wish to return to "business as usual," with no public memory of the bailout or the lasting impact to the American taxpayer. Enduring progress will not be easy, but it can, and must, be achieved.

[3] Testimony of Treasury Secretary Timothy F. Geithner, Senate Banking Committee, June 18, 2009.